Office of
Tax Simplification

Property income review:
simplifying income tax for residential landlords

25 October 2022

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Foreword

In this report, the Office of Tax Simplification (OTS) considers the UK taxation of income from residential property, primarily in relation to individuals. Nearly one in ten Income Tax payers have income from property, underlining its importance within the UK economy and tax system.

The public interest in property taxation is reflected in the responses the OTS received to the Call for Evidence and the Survey issued in respect of this review. The Survey was completed by 3,559 individuals, the highest survey response the OTS has received. As part of collecting evidence for the review, members of the OTS team spoke at the Landlords Expo event, where they were able to collect informal comment from a broad range of members of the public.

The report builds on the comments made by the wide range of those who responded to bring together a number of recommendations in respect of the taxation of property income received by individuals, for possible action over the short and medium term. It also makes recommendations for improved guidance in a number of areas.

The OTS is grateful to all those who willingly gave time, ideas, challenge and support over the course of over 35 meetings and 27 written submissions. The OTS is also very grateful to the members of the OTS Board for their helpful steers and insights and to HM Treasury and HM Revenue & Customs colleagues for their engagement.

The OTS would like to thank Sally Campbell, Patricia Mock and Julia Neate who led the review, supported by Emma Baylis, Mark Frost, John Hall, Zoe Judd, Bethan Kay, Claire McEvoy, Andy Richens and Graham Spencer, guided by OTS Head of Office James Konya.

Kathryn Cearns – OTS Chair

Bill Dodwell – OTS Tax Director

Executive summary

This report considers the complexities and challenges of the taxation of income from residential property, looking primarily at what the Income Tax legislation refers to as a property business. The vast majority of issues raised by respondents concerned Income Tax, rather than Corporation Tax, and the focus and findings of the report reflect that.

Residential property is an unusual asset class, in that it can be treated for tax purposes as a place to live, an investment, a business, or even as a trade, with quite different tax consequences. Outside pensions and cash savings property is also one of the biggest investment classes in the UK, with more individuals owning rental property than hold stocks and shares ISAs.

Across the spectrum of sophistication and scale of activities, 2.9 million individual taxpayers[1] must face the rules for taxation of income from property. This report contains findings and recommendations to help reduce complexity and enhance understanding of taxpayers' obligations.

Key findings and priority recommendations

Furnished holiday lettings

- Short term rentals meeting the conditions fall into the furnished holiday lettings regime. This regime provides more favourable tax treatment than the main property income rules, with more tax relief for costs, including interest, and potentially a reduced Capital Gains Tax bill on disposal.
- Around 127,000 furnished holiday lettings businesses owned by individuals[2] are declared to HMRC in personal tax returns, including 17,000 relating to properties in the European Economic Area (EEA). The widely held view of respondents was that this represents a relatively small core of people running a substantial short term letting business, and a long tail of second-home owners renting one property.
- Respondents in general were neutral on the benefits of the regime compared to its administration, and those who were positive felt the scope of who was included was too wide. The key benefits are seen as the availability of full relief for interest and the reduction in Capital Gains Tax

[1] This is the number of property businesses disclosed to HMRC on Self Assessment tax returns for 2019-20 (excluding partnership property businesses). It may be more than the number of individuals with property rental income as an individual may have both UK and foreign properties which would be counted as two businesses.

[2] As above a taxpayer may declare either or both of a UK and EEA furnished holiday lettings business.

on disposal. The OTS questions the need for a separate rule set of this nature.

- The OTS recommends that the government consider whether there is continuing benefit to the UK in having a separate tax regime for furnished holiday lettings.
- The OTS recognises that removing the furnished holiday lettings regime could put pressure on the boundary between whether a taxpayer has a property business or a trade, as many would currently use that regime as a proxy for many of the benefits of the trading rules.
- If the furnished holiday lettings regime is abolished the OTS recommends that the government consider whether certain property letting activities subject to Income Tax should be treated as trading and whether it would be appropriate to introduce a statutory 'brightline' test to define when a property trading business is being carried on.
- If the regime is retained, the introduction of a private use restriction may allow for relaxation of other requirements to enter the regime, making it simpler to understand and predict whether one is in scope.
- Should the government conclude that the furnished holiday lettings regime be retained, the OTS recommends that the government then consider:
  - removing the current distortion of allowing the regime for properties in the European Economic Area, either by permitting worldwide properties to qualify, or by limiting the regime to UK properties
  - restricting the regime to properties used for commercial letting by removing the potential for personal occupation. This would permit a simpler approach to defining the regime

Repairs, replacements, and improvements

- A long-standing area of complexity for taxation of property is whether costs are allowable as a deduction from rental profits as repairs and replacements or represent capital expenditure as improvements and should be disallowed for Income Tax.
- The response to the Call for Evidence made it clear this is still an area of great uncertainty, not just for landlords themselves, but also for advisers and HMRC staff.
- The OTS recommends that HMRC should enhance the guidance in respect of the boundary between repairs and improvements to include clear examples of common situations, perhaps using flow-charts to lead towards case-by-case answers.
- The boundary between capital and revenue costs is not easy to follow and the rules on replacements and improvements are also hard to interpret, particularly as building standards change over time.
- The OTS recommends that the government consider introducing a broader immediate Income Tax relief for all property costs - other than where work is part of the capital cost of the building, such as the initial fit-out of

properties bought in a dilapidated state or structural work such as extensions to the property.

- This would be simpler for landlords and HMRC to administer and would also support the government's objective in improving the environmental standards of rented property, by offering certainty of tax relief for those costs.

- Any costs allowed for Income Tax would (as is the case under current rules) not be allowable for Capital Gains Tax.

Jointly owned property

- HMRC data indicates that almost half (1.5 million) of all taxpayers renting out property do so jointly, mainly with a spouse or civil partner, or with others.

- Those not married nor in civil partnership will by default declare the split of income based on beneficial ownership but can instead choose any other split they like without any form of election.

- Conversely, spouses and civil partners, (providing they are living together) default to equal 50:50 shares for property other than furnished holiday lets, and respondents made very clear that the process to instead use a split based on beneficial ownership (using form 17) is complex and burdensome even for advisers, and taxpayers themselves are normally unaware of the need. This creates an unnecessary complexity and burden, and potentially accidental non-compliance.

- The OTS recommends that the government should consider removing the anachronistic 50:50 rule for spouses and civil partners and aligning treatment to that of other joint owners and to the position for spouses under Capital Gains Tax and Inheritance Tax. To prevent abuse, the default beneficial ownership position should not be capable of being displaced.

- The government may also wish to consider removing the ability for joint owners to decide on a split other than beneficial ownership.

Making Tax Digital for Income Tax

- From April 2024, landlords in scope of Making Tax Digital (MTD) for Income Tax will need to keep digital records and file updates quarterly using compatible software. There was a very high level of concern common to all respondents about how the rules would apply to landlords. Three issues in particular have been common areas of concern to respondents.

- Nearly half of landlords will be filing in respect of jointly owned property, and it is not clear how this will be possible under the current proposals given it is normal for only one party to keep records. This is comparable to the situation with nominated partner in a partnership, where HMRC accepts that a different approach is needed for MTD for Income Tax.

- The OTS recommends that HMRC should establish a system to deal with MTD for Income Tax for jointly owned properties, for example by making a jointly owned property the MTD filing entity.

- Landlords may rely on multiple parties to provide information and potentially to support submitting reports.
- HMRC needs to be able to authorise MTD for Income Tax filing agents alongside tax agents. This is needed because letting agents and bookkeepers will maintain digital records and may support quarterly submissions on behalf of some landlords. Specific professional standards and responsibilities will be needed for MTD for Income Tax filing agents.
- The gross rental limit for being required to adopt MTD for Income Tax has been set at £10,000. The evidence suggests that a landlord with such low gross rentals will have a modest net profit, if any. The OTS acknowledges that, although there would be an Exchequer impact on raising the threshold, this could be outweighed by lower customer costs, higher levels of compliance and better taxpayer and agent engagement.
- The OTS recommends that HMRC give consideration to increasing the minimum gross income threshold for MTD for Income Tax for landlords above £10,000, at least for the medium term.
- As is clear from the points above there are unresolved complexities within MTD for Income Tax.
- The OTS recommends that MTD for Income Tax should not apply to landlords until these major points have been dealt with by HMRC and by a range of software providers. Time will be needed to test new systems before adoption.

Diversified agricultural based businesses

- Over recent years, 66% of agricultural businesses are diversified, needing to include other sources of income to maintain the core agricultural production as a viable business; this includes income from property.
- Chapter 2 sets out the many challenges that occur to such businesses in the way the tax system disaggregates the streams of income, including for reporting and availability of reliefs and losses. These were highlighted by the many representative groups who responded.
- The OTS proposes that if government are of the view that support be made available to secure UK agricultural production, then HM Treasury and HMRC work with the Department for Environment, Food & Rural Affairs (Defra) to explore the potential for a 'Rural Business Unit' or similar regime for tax, with a view to simplifying the obligations on relevant parties and reducing the complexity of rules applying to diverse rural businesses.
- A potential model for this could be the Rural Business Unit set out by the Country Land and Business Association (CLA), as illustrated in Chapter 2.

Non-UK residents

- Non-UK resident landlords are taxable in the UK on income from land. Significant elements of the administration for non-UK residents present challenges, including registration for online services and in some cases no online service being provided by government. The OTS makes recommendations within the report to address the challenges found by taxpayers affected.

- Unless a non-UK resident landlord registers to file and pay with HMRC, the Non-Resident Landlord Scheme requires the deduction of tax at source from rents paid to them. This obligation falls on letting agents or, if there are none, on tenants.[3]

- No respondents the OTS spoke to were aware of any instances where residential tenants withheld tax, and the general view was that this obligation was not widely understood. No HMRC data is available to substantiate whether tenants withhold.

- The OTS recommends that the government consider reviewing the policy of tenant withholding given the potential burden and its effectiveness for residential tenants. If tenant withholding is retained, the government could consider raising the threshold, making the withholding obligation on tenants clearer in guidance and finding ways to raise awareness, and clarifying the process to rectify matters if tenants initially do not withhold.

Structure of the report

Chapter 1 provides an overview of property as an asset class for tax and looks at the reasons people choose to become residential landlords alongside some select demographic characteristics.

Chapter 2 gives an overview of the general regime for Income Tax on property and the distinctions from the rules which tax trading income. Chapter 2 questions the need for multiple interpretations of 'business' to apply to property across the taxes. Chapter 2 also looks at the complexity arising for diversified agricultural businesses that include income from property.

Chapter 3 considers ownership and financing matters. The chapter first deals with differences in treatment for spouses and civil partners compared to other joint owners, and makes recommendations for equalising treatment to remove administrative complexity; it then covers restrictions on finance costs, including in comparison to incorporated property businesses.

Chapter 4 provides an overview of the property allowance and Rent a Room relief and looks at the interactions between the two.

Chapter 5 looks at the long-standing complexities arising from the need to disallow expenses relating to personal use and to any capital expenditure. In relation to the latter, this chapter also sets out an alternative to the current rules for repairs and improvements.

Chapter 6 provides details on the furnished holiday lettings regime, and the distinctions from the main property taxation rules for Income Tax. The report recommends the removal of the regime, and provides a potential statutory brightline test between property letting and trading income in case the removal creates boundary complexity. Chapter 6 also suggests ways to make the furnished holiday

[3] If there is no letting agent the tenant must deduct tax if rents are over a threshold of £100 per week.

lettings regime more targeted if it is not removed, and that government consider the appropriateness of having an European Economic Area regime.

Chapter 7 looks at what Making Tax Digital for Income Tax will mean for property businesses, including the complexity of joint ownership, the need for multiple agent access, and the impact on landlords with small amounts of income.

Chapter 8 explores the regime for taxation of non-UK resident landlords, including the extent to which the regime remains paper-based, and the burden and practicality of the obligation for residential tenants to withhold.

The Annexes provide additional material to support the report, including the results of the OTS Survey, examples, and collated lists of recommendations, as noted in the contents.

Recommendations by priority and area

Key recommendations for policy change

These recommendations arise from a weight of evidence in responses demonstrating either:

- confusion and challenge raised by large numbers of respondents (such as form 17 and joint ownership, or the distinction of replacements and capital), or
- concern or confusion in relation to rules which cause significant distortions or complexity (such as the furnished holiday lettings regime, or the circumstances for diversified agricultural businesses)

All of these recommendations will have Exchequer impacts, which the government will need to balance against the reduction in administrative costs, the non-compliance respondents identified, and the goodwill and engagement of taxpayers. More details are in the relevant chapters.

Furnished holiday lettings (Chapter 6)

- The OTS recommends that the government consider whether there is continuing benefit to the UK in having a separate tax regime for furnished holiday lettings.
- If the furnished holiday lettings regime is abolished the OTS recommends that the government consider whether certain property letting activities subject to Income Tax should be treated as trading and whether it would be appropriate to introduce a statutory 'brightline' test to define whether a property trading business is being carried on.
- Should the government conclude that the furnished holiday lettings regime be retained, the OTS recommends that the government then consider:
    - removing the current distortion of allowing the regime for properties in the European Economic Area, either by permitting worldwide properties to qualify, or by limiting the regime to UK properties
    - restricting the regime to properties used for commercial letting by removing the potential for personal occupation. This would permit a simpler approach to defining the regime

Replacements and improvements (Chapter 5)

- The boundary between capital and revenue costs is not always easy to follow and the rules on replacements and improvements are also hard to interpret, particularly as building standards change over time.
- The OTS recommends that the government consider introducing a broader immediate Income Tax relief for all property costs - other than where work is part of the capital cost of the building, such as the initial fit-out of properties bought in a dilapidated state or structural work such as extensions to the property.
- This would be simpler for landlords and HMRC to administer and would also support the government's objective in improving the environmental

standards of rented property, by offering certainty of tax relief for those costs.

- Should the government not adopt a broader relief, then the existing guidance will need to be enhanced.
- The OTS recommends that HMRC should enhance the guidance in respect of the boundary between repairs and improvements to include clear examples of common situations, perhaps using flow-charts to lead towards case-by-case answers.

Default income shares for spouses and civil partners (Chapter 3)

- The OTS recommends that the government should consider removing the anachronistic 50:50 rule for spouses and civil partners and aligning treatment to that of other joint owners and to the position for spouses under Capital Gains Tax and Inheritance Tax. To prevent abuse, the default beneficial ownership position should not be capable of being displaced.
- The government may also wish to consider removing the ability for joint owners to decide on a split other than beneficial ownership.

Thresholds for landlords under Making Tax Digital for Income Tax (Chapter 7)

- The OTS recommends that HMRC give consideration to increasing the minimum gross income threshold for MTD for Income Tax for landlords above £10,000, at least for the medium term.

Diversified agricultural businesses (Chapter 2)

- The OTS proposes that if government are of the view that support be made available to secure UK agricultural production, then HM Treasury and HMRC work with the Department for Environment, Food & Rural Affairs (Defra) to explore the potential for a 'Rural Business Unit' or similar regime for tax, with a view to simplifying the obligations on relevant parties and reducing the complexity of rules applying to diverse rural businesses.

Other recommendations for policy change

The following recommendations similarly represent evidence from multiple sources of challenge and complexity, but are potentially of more narrow application. In the case of the first, for example, many will already be obliged to pay other forms of National Insurance contributions.

Some of these recommendations will have Exchequer impacts, which as for the priority recommendations the government will need to balance against the reduction in administrative costs, the non-compliance respondents identified, and the goodwill and engagement of taxpayers. More details are again in the relevant chapters.

Eligibility for voluntary payment of Class 2 National Insurance contributions (Chapter 2)

- The OTS recommends that the government consider adopting a simplified approach that property letting income can in no circumstances make taxpayers eligible for Class 2 National Insurance contributions.

Restriction of finance costs when using cash basis (Chapter 3)

- The OTS recommends that the government consider whether the rules for restricting the level of interest relief when the cash basis is used add unnecessary complexity, and whether the rules should be consistent with those applying when the accruals basis is used.

Non-Resident Landlord Scheme withholding obligation on tenants (Chapter 8)

- The OTS recommends that the government consider reviewing the policy of tenant withholding given the potential burden and its effectiveness for residential tenants. If tenant withholding is retained, the government could consider raising the threshold,[4] making the withholding obligation on tenants clearer in guidance and finding ways to raise awareness, and clarifying the process to rectify matters if tenants initially do not withhold.

Recommendations for HMRC technology

These recommendations relate to the provision or alteration of digital tools and related processes, and so consideration must be given by government to the relative priority of spending and resource.

The following changes should be made quickly to prevent Making Tax Digital (MTD) for Income Tax creating significant cost and burdens on reporting landlords (Chapter 7):

- The OTS recommends that HMRC should establish a system to deal with MTD for Income Tax for jointly owned properties, for example by making a jointly owned property the MTD filing entity.
- HMRC needs to be able to authorise MTD for Income Tax filing agents alongside tax agents. This is needed because letting agents and bookkeepers will maintain digital records and may support quarterly submissions on behalf of some landlords. Specific professional standards and responsibilities will be needed for MTD for Income Tax filing agents.
- The OTS recommends that MTD for Income Tax should not apply to landlords until these major points have been dealt with by HMRC and by a range of software providers. Time will be needed to test new systems before adoption.

This recommendation will need to be factored into HMRC's ongoing transformation programmes, potentially making it a longer-term project (Chapter 8):

- The OTS recommends that HMRC review whether the provision of online Self Assessment tax return filing can be expanded so that non-UK residents no longer need to complete a paper form or file using commercial software.

These recommendations are not directly linked to HMRC's transformation programmes, and could conceivably be delivered quickly (Chapter 8):

- The OTS recommends that HMRC update the Government Gateway process so it is easier for non-UK residents to obtain the relevant ID and password

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[4] Tenant withholding may apply if there is no letting agent and rents are over a threshold of £100 per week.

and manage their affairs online. This could include increasing the length of time the activation code takes to expire for non-UK residents.

- The OTS recommends introducing online options for the quarterly reporting (form NRLQ) which can currently only be filed as a paper report. The OTS also recommends that the paper option for the year-end reporting (NRLY) can be completed on-screen for example by providing an editable PDF.

Annex B also contains a list of recommendations relating to guidance, with links to the relevant pages. The OTS considers as a general principle that improvements to guidance should be quick wins for HMRC.

All recommendations are listed by Chapter in Annex A.

Chapter 1

Becoming a landlord, how this is structured and how income is taxed

1.1 Property, especially residential property, is an unusual asset class, in that it can be treated for tax purposes as a place to live, an investment, a business, or even as a trade. It is also one of the biggest investment classes in the UK (outside pensions and cash savings), with more people owning rental property than hold stocks and shares ISAs.[1]

1.2 The tax consequences of the different ways of taxing property are illustrated below, with a comparison to an investment in quoted shares or a collective investment. Furnished holiday lettings, which are held by about 127,000 property businesses owned by individuals are treated more favourably than other property rentals, with greater tax relief for costs, including interest, and the potential for lower capital gains tax rates on disposal.

1.3 Most issues raised by respondents to the OTS Call for Evidence and Survey concerned Income Tax, rather than Corporation Tax so the table below reflects the position for individuals, rather than companies.

[1] HMRC data for 2019-20 shows that there were 2.9 million property businesses owned by individuals (excluding partnership property businesses) where income was declared in personal tax returns, compared to 2.7 million with a stocks and shares ISA shown in the following - Commentary for Annual savings statistics: June 2021 - GOV.UK (www.gov.uk).

	Rental property	Furnished holiday let	Trade (such as bed and breakfast)	OEICs/listed shares (outside ISA)
Transaction tax[2]	5-15%	5-15%	Mixed use rates	0.5%
Repairs	Deductible	Deductible	Deductible	
Equipment	Replacements deductible	Capital allowances	Capital allowances	
Improvements or enhancements	CGT relief only	Capital allowances /CGT relief	Capital allowances /CGT relief	CGT relief only
Tax relief on interest	Basic rate only	Full relief	Full relief	No relief
Income tax rates[3] [4]	Marginal rates 20-45%	Marginal rates 20-45%	Marginal rates 20-45%	Dividend rates 8.75%/33.75%/ 39.35%[5]
Allowances[6]	£1,000-£7,500[7]	£1,000[8]	£1,000-£7,500[9]	Dividend allowance £2,000
National Insurance contributions	No	No	Class 2 £3.15pw and Class 4[10]	No
Capital Gains Tax (CGT)	18-28%	18-28% subject to Business Asset Disposal Relief[11]	18-28% subject to Business Asset Disposal Relief	10-20%

2 This refers to Stamp Duty Land Tax and Stamp Duty Reserve Tax. Rates quoted are for England and assume property bought other than as a main residence. Land transaction taxes are devolved to Scotland and Wales.

3 Income tax rates and thresholds in relation to property income have been devolved to Scotland and tax rates devolved to Wales. The rates shown are the UK rates.

4 The government announced on 23 September 2022 that it intends to abolish the 45% rate of Income Tax from 6 April 2023; however this announcement was revoked on 3 October 2022.

5 The rates shown relate to 2022-23 and were increased by 1.25% from 6 April 2022 in parallel with the introduction of the Health and Social Care Levy. It was announced on 23 September 2022 that the Government plan to reverse this increase from 2023-24; however this announcement was revoked in respect of dividends on 17 October 2022, so the higher dividend rates continue to apply.

6 Trading allowance, property allowance and Rent a Room relief.

7 Rent a Room relief of £7,500 may apply, or the £1,000 property allowance. In both cases, actual expenses cannot be claimed.

8 Property allowance of £1,000 may apply. Actual expenses cannot be claimed.

9 Rent a Room relief of £7,500 may apply, or the £1,000 trading allowance. In both cases, actual expenses cannot be claimed.

10 NIC rates are found at: Rates and allowances: National Insurance contributions - GOV.UK (www.gov.uk).

11 Business Asset Disposal Relief gives a Capital Gains Tax rate of 10% on capital gains up to £1m, subject to specified conditions. Business Asset Disposal Relief: Eligibility - GOV.UK (www.gov.uk).

Why do people become residential landlords?

1.4 HMRC's data for 2019-20 indicates that 2.9 million property businesses (excluding partnership property businesses) declared property income in personal tax returns, meaning that nearly a quarter of all individual tax returns submitted included property income. The 2021 English Private Landlord Survey[12] identifies that by far the most common reasons people rent out land and property are to generate income and with a view to realising a gain on the capital when they finally sell.

1.5 Some make a deliberate choice to buy property with a view to letting it, commonly considering it carefully against other options for investment of their money and time. The English Private Landlord Survey identifies this as 52% of landlords. Others will come into a situation where rental is an option by circumstance, such as retaining their own home after moving elsewhere (35%), or through inheritance (7%).[13]

1.6 Respondents to the OTS's Call for Evidence and Survey highlighted that there tends to be a difference in the tax understanding and awareness between those who plan to start a rental business and those who find themselves running one by circumstance, with the latter typically needing more support.

1.7 Many people who responded to the OTS Survey highlighted how much time and work goes into running their property or properties as a business, regardless of how they came by them.

Select demographic characteristics of landlords

1.8 As part of the Call for Evidence, the OTS ran a Survey which included questions about the characteristics of landlords. Full results from the Survey, which was completed by 3,559 individuals, are contained in Annex C. The OTS has also considered data from HMRC and information from the English Private Landlord Survey (the latter as a proxy for the wider UK).

1.9 Both HMRC tax return data and the 2021 English Private Landlord Survey indicate that the gender split of landlords is roughly equal between male and female, with more identifying as male.[14] The English Private Landlord Survey also presents the gender ownership split broken down by number of properties, with a broadly equal male and female split up to 1- 4 properties, but male ownership share gradually increasing for larger property portfolios.

1.10 In terms of age demographics, the English Private Landlord Survey shows 63% of landlords are 55 or older, with a further 22% in the 45-54 bracket just below that. The result from the OTS Survey was similar, but with fewer respondents of 65 and over.

1.11 The English Private Landlord Survey also shows that for landlords operating as one or more individuals (rather than operating as companies), nearly half (45%) owned only one property, and overall, the vast majority (85%) owned less than five. This mirrors the responses to the OTS Survey.

12 English Private Landlord Survey 2021: main report - GOV.UK (www.gov.uk), May 2022.

13 These proportions roughly match responses to the OTS's own Survey (see Annex C).

14 43.9% identified female, 55.3% male, 0.7% other in the 2021 EPLS.

Types of ownership, uses and tax treatment

1.12 Discounting ownership through companies, an individual person can own a property alone as an individual, or with someone else as either 'joint tenants', 'tenants in common'[15] or as partners in a partnership. Respondents to the OTS Survey indicated that almost half was jointly owned:

Owned alone	Jointly owned		
	With spouse or civil partner	With other(s)	In a partnership
40.5%	40.9%	4.6%	2.7%

1.13 Of the remaining responses, 8.8% of properties were owned by companies, and 2.6% responded 'other' with most of those declaring a combination of different types of ownership for different properties. Ownership through a trust was also mentioned in these responses although this is not dealt with in this review.

1.14 This large proportion of joint ownership is also reflected in HMRC tax return data for 2019-20 which showed 47% of returns specified joint ownership of property. The different types of joint ownership and their tax consequences are explored in Chapter 3.

Wider market context

1.15 Landlords have a duty of care[16] to their tenants, which is enshrined in legislation. This includes a requirement that residential rented accommodation is provided and maintained in a state of fitness for human habitation. There are mandatory licensing requirements for property with multiple occupation (three or more people), and a local authority can create additional licensing schemes that apply to all properties in a specific area, regardless of size.

1.16 Local authorities can issue civil penalties for any breach of regulations, with serious cases using a banning order to prevent a landlord from renting out any property. There is a 'rogue landlord database' accessed by local authorities and a specific London database[17] can also be accessed by the general public.

1.17 All landlords must adhere to fire safety principles and are responsible for ensuring that all gas and electrical appliances are maintained in a safe condition.[18]

1.18 Currently all[19] residential tenancies must have a minimum Energy Performance Certificate rating of 'E' or above, but as explained in Chapter 5, there are proposals that this requirement will be tightened to 'C' or above from 2025 for new tenancies and 2028 for existing ones. An Energy Performance Certificate is not required for holiday accommodation which is rented out for

15 Joint property ownership: Overview - GOV.UK (www.gov.uk).

16 Being a landlord and renting out a room - GOV.UK (www.gov.uk).

17 Check a landlord or agent | London City Hall.

18 Private renting: Your landlord's safety responsibilities - GOV.UK (www.gov.uk).

19 In England and Wales; different rules apply in Scotland and Northern Ireland. There are some limited exceptions.

less than four months a year or is let under a 'licence to occupy' where the landlord is responsible for the energy bills.[20]

1.19 For lettings of domestic accommodation, Council Tax is due on each rental property, which is generally the responsibility of the tenant. Landlords are responsible for Council Tax payable on empty properties and holiday homes. However, if a holiday home is categorised as self-catering holiday accommodation which is let,[21] then the owner may have to register for business rates instead of Council Tax. The parameters for eligibility for business rates differ to those for the furnished holidays lettings tax regime (see Chapter 6).

1.20 Business rates are applied differently in each devolved region of the UK, but a common feature is that owners of self-catering holiday accommodation can apply for the relief for small businesses. This is calculated using factors such as the rateable value of the property, the number of properties owned by the landlord and the number of days it is let, but there is the potential for holiday accommodation to pay little or no business rates in addition to no Council Tax.

1.21 Some respondents to the OTS Survey commented unfavourably on the regional disparities in the application of business rates and the availability of the small business relief. Business rates are outside the scope of this review.

20 Buying or selling your home: Energy Performance Certificates - GOV.UK (www.gov.uk).

21 Business rates: Self-catering and holiday let accommodation - GOV.UK (www.gov.uk).

Chapter 2

The general tax regime for property income

Introduction

2.1 Since the start of the 'Schedular' system in 1803, when different income types were split into different legislative Schedules for tax, property has been treated as a separate category, different to trading. The original 'Schedule A' taxed the annual value of land holdings alongside income from ownership. Whilst the UK has not taxed the value of land like that since 1964, modern legislation[1] still retains different treatment for the taxation of income from land (which includes buildings)[2] to income from trading.[3]

2.2 This principle applies equally to individuals (including partners) under Income Tax, and companies under Corporation Tax. This chapter looks at Income Tax, while the position for companies is briefly discussed in Chapter 3.

2.3 The main principle is that a property business is not normally a trade, irrespective of the amount of time and effort put in by the landlord in collecting rents, dealing with repairs, and so on. Recent tax cases have shown that typically these types of expense are not sufficient to make the activities a trade. Many people the OTS spoke to felt that they were carrying on a business without necessarily understanding what this meant for their taxes.

2.4 If there is no trade, the tax legislation taxes income from a 'property business' as outlined below.

2.5 In certain circumstances a trade may be being carried on using property, for example a bed and breakfast or hotel. In such cases the activities are taxed as such under the legislation relating to trades.

2.6 There is also the furnished holiday lettings regime, which applies to certain short term lettings. Although the property income rules apply to furnished holiday lets, some additional reliefs normally reserved for trading are given; these rules dealt with in Chapter 6.

2.7 As a further complication the word 'business' means something different for different taxes that also apply to property, so that 'business' for Inheritance Tax means something different to 'business' for Capital Gains Tax and something different again for National Insurance contributions. This is covered later in this Chapter.

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1 Part 3 Income Tax (Trading and Other Income) Act 2005, Part 4 Corporation Tax Act 2009.

2 In turn defined as exploiting an estate, interest or right over land, as a source of rent or other receipt.

3 Part 2 Income Tax (Trading and Other Income) Act 2005.

2.8 This chapter seeks to explain the complexities noted above and set out the case for simplification.

UK property business

2.9 The starting point belies the differences, in that profits of a property business are calculated in the same way as the profits of a trade. But the Income Tax property business rules (outside of the furnished holiday lettings regime) then differ in certain key ways:

- property losses may only be carried forward against profits of the same property business
- a separate allowance for replacement of domestic items is given instead of capital allowances on fixtures and furnishings
- tax relief for finance costs is restricted to the basic rate
- where certain conditions are met, the cash basis is the default for businesses with a turnover up to £150,000, with an option to apply the accruals basis (for trading the default is the opposite)

2.10 All UK property rental activities will form one UK property business for tax, with furnished holiday lettings income and expenses distinguished from that one business for certain (but not all) purposes. That means that rental income and expenses will each be aggregated, so common expenses need not be apportioned against multiple properties. An annual property allowance of £1,000 may be claimed instead of allowable expenditure and relief for interest (see Chapter 4).

2.11 Profits from land situated in the UK are taxable regardless of whether the person is UK resident or not, with Double Taxation Treaties supporting the UK's primary taxing rights.

2.12 Currently for Income Tax purposes the assessment of property business profits is on a tax year basis, irrespective of the date to which any accounts are prepared.[4] From 2023-24 onwards, amendments in the Finance Act 2022 will allow an equivalence between 31 March and 5 April.[5] Partnerships running both a trade and property business may currently use the accounting period of the trade, but this will change from 2023-24, when all such businesses will follow the tax year basis (or use 31 March under an equivalence basis).

Overseas property business

2.13 All overseas property rental activities will similarly form one overseas property business. As for the UK equivalent, EEA properties in the furnished holiday lettings regime are included in this single business for some things, but distinct for many others. To be assessable to UK Income Tax an overseas property business must be carried on by a UK resident person.

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[4] PIM1102 under 'Further examples' allows equivalence between 31 March and 5 April where not using the cash basis and the amounts are small. PIM1102 - Use of trading income rules: splitting receipts and expenses between years: examples - HMRC internal manual - GOV.UK (www.gov.uk).

[5] See prospective new ss275A -275C ITTOIA, inserted by s8 Finance Act 2022.

2.14 HMRC provide some guidance on this in a webinar on foreign rental income,[6] and in a YouTube video on foreign income.[7] Despite this, respondents identified a lack of awareness, particularly amongst those moving to the UK, that overseas property income is taxable in the UK, having likely been taxed overseas. HMRC could work with advisory representative bodies, and potentially with parties dealing with those immigrating to the UK and selling foreign property to UK residents, to explore how better to publicise this.

Recommendation

HMRC should consider working with relevant third parties on how to improve awareness of UK tax obligations regarding overseas property income and provide better signposting to guidance.

2.15 Respondents also highlighted the complication of overseas tax years not corresponding to the UK tax year, meaning overseas tax is calculated and reported on a different basis. It is currently not uncommon for businesses to prepare their overseas property business computations informally to the overseas tax year date. However, this approach is not correct, and runs contrary to the changes to the basis period rules which will bring trades into line with property businesses and apply a tax year basis from 6 April 2023.[8] The difficulties for taxpayers with overseas income taxed overseas on a different tax year basis was discussed in the OTS report 'The UK tax year end date; exploring the potential for change', published in September 2021,[9] summarising that a UK tax year end of 31 December, aligning with most of the G20 countries, would be the simplest approach, but setting out the challenges facing such a change.

Is the income from a property business taxed as a trade?

2.16 The letting of a residential property is, as set out above, taxed as a property business. In some circumstances a trade may be being carried on, for example a person letting short term furnished property alongside hospitality services (such as a hotel) is likely to be conducting a trade.

2.17 As set out above, a trading business operates under different rules,[10] many of which are more flexible or provide access to reliefs and allowances not available to a property business (including potentially capital taxes business asset reliefs).[11]

6 HMRC email updates, videos and webinars for Self Assessment - GOV.UK (www.gov.uk).

7 Do I need to declare foreign income to HMRC? - YouTube.

8 S7A-7D Income Tax (Trading and Other Income) Act 2005, inserted by Schedule 1 FA2022.

9 Tax year end date report (publishing.service.gov.uk).

10 Part 2 Income Tax (Trading and Other Income) Act 2005, Part 3 Corporation Tax Act 2009.

11 Capital Gains Tax Rollover Relief and Business Asset Disposal Relief, with Inheritance Tax Business Relief (Business Property Relief).

2.18 There is no general legislative definition of trade, instead relying on the 'badges of trade'[12] set out by the Royal Commission on the Taxation of Profits and Income in 1955, and subsequent case law. For property income, recent (non-binding) case law from the First-tier Tribunal (Tax)[13] and HMRC guidance[14] consider two principal factors: whether the landlord is in actual occupation of the property and whether services are provided beyond those normally provided by a landlord, for example provision of bed and breakfast, or a guest house or hotel.

2.19 The legislation[15] automatically treats the following activities as a trade:

a) farming or market gardening in the UK

b) profits from mines, quarries and so on

c) any other occupation of the land managed on a commercial basis with a view to profit, other than merely the letting of property

2.20 Outside of the specific instances in statute, this lack of clarity over the boundary with trading was strongly evident in responses to our consultation despite the case law. Given the different tax and National Insurance contributions outcomes this is an important distinction. Several professional bodies were of the view that many property businesses would be treated as a trade following the 'badges' if the owning of the property were to be ignored. The *Julian Nott* case referred to above acknowledged these difficulties, and a number of respondents were quite adamant that their level of activity in managing an extensive property portfolio was worthy of access to equivalent tax treatment to those in trade.

2.21 The OTS has reviewed whether the trading/investment distinction is outdated in two previous reports,[16] and it is not explored further here. Regarding the uncertainty over the boundary, the concept of a brightline trade test is discussed in Chapter 6.

National Insurance contributions

2.22 Following a change in legislation,[17] from 6 April 2015 liability to Class 2 National Insurance contributions only arises if the earner has 'relevant profits'. 'Relevant profits' for this purpose are the profits for Class 4 National Insurance contributions purposes, that is profits from a trade, profession or vocation.

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12 HMRC currently consider nine badges: profit seeking motive, number of transactions, nature of the asset, changes to the asset, source of finance and how purchased, changes to the asset, reason for sale, length of ownership and whether similar trade carried on, see HMRC guidance Business Income Manual (BIM) 20200. BIM20200 - Meaning of trade: badges of trade: contents - HMRC internal manual - GOV.UK (www.gov.uk).

13 Julian Nott v HMRC [2016] UKFTT 106 (TC).

14 BIM22001 - Meaning of trade: exceptions and alternatives: furnished lettings - HMRC internal manual - GOV.UK (www.gov.uk) and PIM4300 - Rents related to a trade or profession - HMRC internal manual - GOV.UK (www.gov.uk).

15 S267 ITTOIA 2005, s208 CTA2009.

16 Review of the competitiveness of the UK tax administration, October 2014 and Simplification of the corporation tax computation, July 2017.

17 New S11(2) SSBA 1992.

Unless the property business is a trade (for example a bed and breakfast or similar) it would be outside the scope of this definition, and no Class 2 National Insurance contributions would need to be paid. However, voluntary Class 2 National Insurance contributions, at the same rate, may be made providing the property landlord is recognised under the legislation as an 'earner'.[18]

2.23 Where the property activity amounts to a trade, for example running a bed and breakfast, then Class 4 National Insurance contributions[19] and therefore also Class 2 National Insurance contributions would be due.

2.24 However, the guidance on GOV.UK[20] states:

'You have to pay Class 2 National Insurance if your profits are £6,725 a year or more and what you do counts as running a business, for example if all the following apply:

- being a landlord is your main job
- you rent out more than one property
- you're buying new properties to rent out'

2.25 HMRC guidance for this purpose[21] sets out:

'The nature of property letting requires some activity to maintain the investment, but that is not enough to make it a business. For example, being a landlord normally involves:

- undertaking or arranging for external and internal repairs
- preparing the property between lets
- advertising for tenants and arranging tenancy agreements
- generally maintaining common areas in multi-occupancy properties; or
- collecting rents

In order for a property owner to be a self-employed earner, their property management activities must extend beyond those generally associated with being a landlord (which include, but are not limited to, the above).

For example, ownership of multiple properties, actively looking to acquire further properties to let, and the letting of property being the property owner's main occupation could be pointers towards there being a business for NICs purposes.

If a property owner has an agent who manages their property for them, things that the agent does should be attributed to the owner.'

2.26 It appears that both these pieces of guidance relate to the rules prior to the 2015 changes, although they are still relevant in determining whether the

[18] New s11(6), S2(b) SSBCA 1992.

[19] S15 SSBA 1992.

[20] Renting out your property: Paying tax and National Insurance - GOV.UK (www.gov.uk).

[21] NIM 23800. NIM23800 - Special cases - property letting: business for Class 2 National Insurance Contributions - HMRC internal manual - GOV.UK (www.gov.uk).

property landlord is an 'earner' for the purposes of making voluntary Class 2 National Insurance contributions. Previously, this was the position for compulsory contributions and the guidance should be updated to recognise that the guidance now refers to qualifying for voluntary payment.

2.27 This approach of asking a landlord to consider whether they carry on a 'business' and so can be regarded as an 'earner' in order to establish whether they are able to make voluntary Class 2 National Insurance contributions of £163.80 per annum is unnecessarily complicated for such a modest amount. The OTS conclude a simplified approach should be taken to remove property income from the scope of Class 2 National Insurance. This would affect those individuals who rely on Class 2 National Insurance contributions for entitlements such as the state pension. In such a case, voluntary contributions would be possible under Class 3 National Insurance but at the higher cost of £15.85 per week rather than £3.15. The OTS acknowledge that simplification here is challenging due to the complexities of the underlying benefit system, for example Class 3 offers less benefit entitlements than Class 2.

2.28 Individuals who have paid Class 2 National Insurance contributions in error by relying on the above guidance should, under existing rules, be able to claim a refund for the last six years, although this may affect state pension entitlements.

Recommendations

The OTS recommends that guidance relating to Class 2 National Insurance is updated to reflect the current law.

The OTS recommends that the government consider adopting a simplified approach that property letting income can in no circumstances make taxpayers eligible for Class 2 National Insurance contributions.

Is the property business a 'business'?

2.29 It is unfortunate that the word business is used in different contexts across various legislative provisions all relating to property, such as noted above for Class 2 National Insurance, Capital Gains Tax Incorporation Relief and Inheritance Tax Business Relief (Business Property Relief). The OTS heard this is a matter of confusion for landlords and advisers, and the OTS consider a change in name titles would be helpful. These individuals and advisers need to rely on HMRC guidance for clarification.

2.30 The guidance for the meaning of business for Class 2 National Insurance contributions is set out above.

2.31 A relief applies from Capital Gains Tax when incorporating a 'business'. The guidance for access to Incorporation Relief for Capital Gains Tax purposes[22] states:

'there are the factors that point to the activities involved being broadly what you would expect in a business:

- is there a "serious undertaking earnestly pursued" or a "serious occupation"
- is there an occupation or function actively pursued with reasonable or recognisable continuity?
- is there a certain amount of substance in terms of turnover?
- are the activities conducted in a regular manner and on sound and recognised business principles?
- are they of a kind which, subject to differences of detail, are commonly made by those who seek to profit by them

An important additional factor is the extent of the activities. The First-Tier Tribunal found against Mrs Ramsay[23] partly because it considered that the activities she undertook in relation to her property were "normal and incidental to the owning of an investment property". That was found not to be the correct test in this context:[24]

> 'It is the degree of activity as a whole which is material to the question whether there is a business, and not the extent of that activity when compared to the number of properties or lettings.'

Mrs Ramsay was found to have worked on the property for about 20 hours per week which was seen to be sufficient to indicate carrying on a business.

You should accept that incorporation relief will be available where an individual spends 20 hours a week personally undertaking the sort of activities that are indicative of a business. Other cases should be considered carefully'.

2.32 This personal undertaking point contrasts with the National Insurance guidance set out above, where the existence of a 'business' may be substantiated by attributing an agent's activities in managing the property to the taxpayer.

2.33 A further interpretation of business applies in the guidance on whether a partnership[25] exists where the carrying on of a 'business' is explained as follows:

> ''Business' is defined as including 'every trade, occupation or profession'. So 'business' is a very wide term, embracing almost every commercial activity, and is much wider than trade or profession alone. It includes a business of

22 CG65715 - Transfer of a business to a company: conditions for relief: meaning of 'business' - HMRC internal manual - GOV.UK (www.gov.uk).

23 First Tier: Ramsay v HMRC [2012] UKFTT 176 (TC).

24 On appeal to Upper Tribunal: Ramsay v HMRC [2013] UK0226 (TCC).

25 PM120100 - What is a partnership? - HMRC internal manual - GOV.UK (www.gov.uk).

making investments. Simply making an investment is not enough, there has to be sufficient organisation, continuity to make the activity a business.'

2.34 A significant number of respondents were clear that HMRC adopting different interpretations of 'business' in the context of property, even though across different taxes, was unhelpful and leads to an unclear and inconsistent tax code.

2.35 Another example of the word 'business' having a different definition is that used in Business Relief (Business Property Relief) under Inheritance Tax, where the legislation[26] imposes a different condition. This is referenced further in the brightline property trade test section of Chapter 6 below.

2.36 This is unnecessarily confusing for taxpayers, who tend to assume that an important definitional word used in one tax context means the same when used in a different place.

Recommendation

> The OTS recommends that HMRC guidance adopts a consistent interpretation where possible of the word 'business' in relation to property across its instances in the tax statutes – and uses different words in statutes where there are different meanings.

Diversified agricultural-based businesses

2.37 In recent years, 66%[27] of farming businesses have undertaken some form of diversified activity, and the OTS heard from multiple landowning groups that recent changes[28] have intensified the need for farming businesses to adopt diverse new income streams alongside the core agricultural business in order to maintain that core business as financially viable.

2.38 Examples of these additional sub-businesses are glamping, holiday lets, bed and breakfast, residential lettings, retail shops, visitor attractions, and renewable energy generation. Land may also have been set aside from farming under environmental stewardship agreements. From the point of view of the business these streams of income are inter-dependent parts of an over-arching strategy using the land available to the agricultural business.

2.39 However, the diversified agricultural business faces a number of tax complexities, both administratively in needing to report each stream individually, and practically in restrictive ring-fencing of the profits and losses of the separate streams. The administrative burden will also increase from April 2024 when Making Tax Digital for Income Tax will require quarterly updates for the various trading and property business streams, potentially leading to a substantial increase in advisory fees. The management accounts of the

26 S105(3) IHTA 1984.

27 Source: Future of Farming and Environment Evidence Compendium (Defra September 2017) The future farming and environment evidence compendium - September 2019 edition - GOV.UK (www.gov.uk).

28 Agriculture Act 2020.

business often do not recognise any distinctions, instead reporting on the overall position of the agricultural business.

2.40 The situation is complex and extreme for agricultural businesses, and the diversity is driven by a core intention to secure the agricultural production trade.

Rural Business Unit concept

The Country Land and Business Association (CLA) has for some years promoted the concept of a 'Rural Business Unit',[29] which could enable a primarily agricultural business to elect that all the elements of that business be treated as a single business entity. This could address the significant administrative and practical issues raised.

Recommendation and qualifying conditions

The OTS proposes that if government are of the view that support be made available to secure UK agricultural production, then HM Treasury and HMRC work with the Department for Environment, Food & Rural Affairs (Defra) to explore the potential for a 'Rural Business Unit' or similar regime for tax, with a view to simplifying the obligations on relevant parties and reducing the complexity of rules applying to diverse rural businesses.

2.41 The OTS recognises that allowing one agricultural trade could release trapped losses and thereby reduce the overall tax paid by the business. Additionally, the property activity currently would be excluded from relevant earnings for personal pension purposes and would not normally qualify for capital taxes business asset reliefs. These issues will be a consideration for government to balance with the extent of the compliance burdens currently suffered by the agricultural sector and against the weight to be given to securing agricultural production.

2.42 To prevent complexity from others outside that sector attempting to benefit through distortive or fraudulent changes to their business models, the OTS would recommend that if this were adopted, it should be framed with an aim of securing food production in the UK. Looking to the CLA's own qualifying tests around commercial agricultural activity, consolidated management, minimum land size, and income could be a starting point.

Registration

2.43 Currently taxpayers who are not already registered with HMRC for Self Assessment are obliged to give notice of their liability to Income Tax to HMRC (effectively to register for Self Assessment) within six months following the tax year during which they started to receive rental income.[30] In November 2021

29 Rural_Business_Unit_Report_2022.pdf (cla.org.uk).

30 www.gov.uk/renting-out-a-property/paying-tax.

HMRC published a Call for Evidence[31] asking whether bringing forward the point at which taxpayers identify themselves to HMRC would help compliance with the rules. The responses to the OTS Survey mirrored the responses to HMRC.

2.44 Generally, people felt there was no strong case for bringing forward registration for Self Assessment because:

- taxpayers often need time at the end of the tax year to finalise their liability, especially for low income taxpayers who need to know what income or profits were made over the whole year
- as income tax is an annual tax, it is logical to link registration to the end of the tax year
- if desired, early registration is already possible under the current system. If the deadline were moved to the start of trading rather than the tax year end then everyone would have a different deadline, creating more confusion

2.45 The OTS Survey asked how difficult (on a scale of 1 to 10) people found registering with HMRC. The responses showed that whilst 35% found it relatively easy, with a score of 1, 2 or 3, 31% gave a score of 8, 9, or 10, showing that the current system is difficult for a number of taxpayers.

2.46 Of those that said there were difficulties, this centred around the interaction of the various allowances not being properly explained, which made the decision on whether registration was necessary more difficult.

[31] Call for evidence: Income Tax Self Assessment registration for the self-employed and landlords - GOV.UK (www.gov.uk).

Chapter 3
Ownership and financing

Ownership issues

Joint ownership of property

3.1 Income from a jointly owned property is allocated for Income Tax purposes between individual owners[1] depending on factors such as their legal or beneficial ownership and the nature of the relationship between them, particularly whether or not they are spouses or civil partners,[2] and whether there is a formal partnership or similar agreement.

3.2 HMRC data indicates that 47% - or just under 1.5m - individual taxpayers declaring property income own property jointly. This roughly correlates to the 40% of respondents to the OTS Survey who indicated they owned a property jointly with their spouse or civil partner when taken with a further 5% who owned properties jointly with others.

3.3 Many respondents to the OTS Call for Evidence, particularly professional bodies and agents, said taxpayers had difficulties in understanding the way taxable profits are allocated between joint owners, particularly the 50:50 default split for spouses and civil partners, and the need for an election to disapply it. They also said taxpayers did not appreciate the implications of profit allocation for joint ownership. These issues are explored in more detail below.

Forms of ownership

3.4 In England and Wales real property (land and buildings) may be jointly owned either as joint tenants, or tenants in common.[3] Scotland and Northern Ireland have similar ownership concepts although the terminology is slightly different.[4]

3.5 Joint tenancy is where parties have equal rights to the property and ownership automatically passes to other owners upon death (so you cannot pass your

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1 The report does not consider here ownership by other entities, for example companies.

2 Throughout this chapter, the reference to spouses and civil partners assumes that those spouses or civil partners are living together.

3 Joint property ownership: Check your ownership details - GOV.UK (www.gov.uk).

4 Tax on property, money and shares you inherit: Joint property, shares and bank accounts - GOV.UK (www.gov.uk).

share in a will). For joint tenants, the default position is that legal and beneficial ownership will be the same: equally split between owners.

3.6 Tenancy in common allows for ownership of different shares of the property, which can be passed on in your will rather than it defaulting to the other owners.

3.7 Legal ownership is essentially the name the property is held in at Land Registry, or on the title deeds. Having legal ownership gives those owners the right of control over the property, for example over its sale or transfer. Beneficial ownership is about who benefits from or enjoys the use of the property. In many cases legal and beneficial ownership will be the same, but not always. Beneficial entitlement to the asset and entitlement to the income can also differ.

3.8 For Income Tax other than for spouses and civil partners the income is by default taken to be split in the same proportions as the underlying beneficial ownership of the property. These joint owners may also agree to a different allocation of their choosing, and without any formal election HMRC will accept that income split accordingly for tax.

3.9 For spouses and civil partners, the default position is that income is split equally between them for Income Tax purposes (except in the case of income from a furnished holiday letting which has different rules which are covered in Chapter 6). If as a matter of fact the property is owned by the couple as tenants in common, beneficial ownership is not equal, and each spouse's entitlement to income is the same as their share of beneficial ownership, then they can elect for income to be split in those same proportions for tax purposes. This is a joint election and is made to HMRC using form 17.[5]

Example 1

Andi and Blake (a married couple) own a rental property in Durham, which they bought as tenants in common. The funds contributed were Andi 20%, Blake 80%; beneficial ownership is agreed in those proportions and evidenced by a declaration of trust. Andi and Blake decide they want the income from the Durham property to be taxed according to beneficial ownership. They therefore sign a Form 17 and send it to HMRC with a copy of the trust deed.

Income up to the date of the election is split 50:50 for tax purposes and from the date of the election is allocated 20% to Andi and 80% to Blake, according to the agreed beneficial ownership proportions.

3.10 For all joint owners, different rules apply if the property is held by the partners in a partnership, in which case income is split according to the partnership agreement. Whether a partnership exists depends on the facts of each

[5] Declare beneficial interests in joint property and income - GOV.UK (www.gov.uk).

situation and HMRC give detailed guidance on their views in their Partnership Manual.[6]

3.11 For Capital Gains Tax, gains or losses on the sale of a property are split according to their owners' respective beneficial interests in the property, irrespective of the relationship between the owners.

3.12 For Inheritance Tax, where the property is held as a joint tenancy then each owner will have an equal share in the value of the property. If the property is held as tenants in common, each owner's share will be their respective beneficial interest in the property. Again, spouses and civil partners are treated the same as others.

Form 17

3.13 As mentioned above spouses or civil partners who jointly own property in unequal shares and have the same unequal entitlement to income can make a joint election to HMRC on a form 17 that the couple wish to have the income split for tax purposes on this basis, rather than the default 50:50.[7]

3.14 Form 17 is labelled as a 'Declaration of beneficial interest in joint property and income' and must be submitted alongside evidence of beneficial ownership. Despite this, the OTS has heard form 17 still causes confusion among both taxpayers and their agents. Practical complications also arise for the unwary in that for tax the date of effect of a beneficial ownership change is not the actual date of any agreement, but the date of signature of form 17. The form 17 must be submitted to HMRC within 60 days of the date the form is signed; HMRC generally enforce this time limit strictly.

3.15 A further complication which is often not appreciated is that, where the legal interest is in the name of one spouse or civil partner only but the beneficial interest is held jointly, form 17 is not relevant. In that situation the Income Tax treatment would normally follow the beneficial ownership as outlined above.

Cash basis

3.16 As outlined in Chapter 2, the calculation of the profits of the property business can be made on either the cash basis or the accruals basis with - where certain conditions are met - the cash basis being the default for businesses with a turnover up to £150,000.

3.17 If a property is owned jointly by spouses or civil partners and they are taxed on a 50:50 basis (so no form 17 has been submitted) if one spouse is taxed on the accruals basis the other must use the same basis. This is not the case if the couple have submitted a form 17 when each can choose their own basis of taxation. This can lead to confusion in practice.

Conclusion

3.18 Ownership and the basis for income sharing is currently complex and in some circumstances guidance is vague. The OTS has been told that the form 17 is a

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6 PM133000 - Does a partnership exist? - HMRC internal manual - GOV.UK (www.gov.uk).

7 Declare beneficial interests in joint property and income - GOV.UK (www.gov.uk).

'needlessly complex rigmarole' and difficult for unrepresented taxpayers to understand, even if they are aware of it.

3.19 One of the stated aims of independent taxation in 1990-91 was to '*offer all married women the opportunity to enjoy independence and privacy in their own tax affairs*'.[8] For Income Tax, this seems undermined by the retention of the anachronistic 50:50 rule and the necessity for owners who are married or in a civil partnership to make a complicated election to get to a position that is the default for other owners.

3.20 It is also clear from respondents that the ability for other joint owners to have an allocation of their choosing - outside of any partnership or other formal agreement - allows for tax planning with no economic substance. This also further compounds the distortion of the situation for spouses and civil partners.

Recommendations

The OTS recommends that the government should consider removing the anachronistic 50:50 rule for spouses and civil partners and aligning treatment to that of other joint owners and to the position for spouses under Capital Gains Tax and Inheritance Tax. To prevent abuse, the default beneficial ownership position should not be capable of being displaced.

The government may also wish to consider removing the ability for joint owners to decide on a split other than beneficial ownership.

3.21 For married couples or civil partners who own property as joint tenants, the 50:50 split would continue (as this is in any case the default allocation for joint tenants) and for those who own property as tenants in common, the default split would be on the same basis as the chosen beneficial interest – which already applies for Capital Gains Tax and Inheritance Tax, as outlined above.

3.22 The recommendation would not affect property held by the partners in a partnership, in which case income is split according to the partnership agreement. The current position would be retained.

3.23 The government may also wish to consider removing the default 50:50 split where it applies for income from other forms of property, such as bank or building society accounts,[9] owned by spouses and civil partners.

Interest relief restrictions

3.24 Interest relief can be given for finance costs (for example mortgage or overdraft interest) associated with property purchase, repair, or working capital, and this includes the cost of obtaining finance.

8 Independent Taxation - Hansard - UK Parliament.

9 TSEM9814 - Property held jointly by married couples or civil partners: The 50/50 rule: 50/50 rule and exclusions - HMRC internal manual - GOV.UK (www.gov.uk).

3.25 Since 2017 the extent of the relief has been reduced for property businesses owned by individuals other than furnished holiday lettings. Instead of relief for the interest being given by deducting the amount from rental profits, relief is restricted to the basic rate of tax by means of a tax reduction.

3.26 The change was phased in over four years from 2017-18 to 2020-21. Since 2020-21only a basic rate reduction is given in respect of finance costs.

3.27 The effect of this is two-fold. Higher and additional rate taxpayers will get tax relief for their finance costs at basic rate rather than their top rate of tax. The restriction may also affect other elements of the taxpayer's affairs. Because interest is not deducted in arriving at total income, this amount will be higher than under the old rules and as well as potentially pushing a taxpayer into a higher rate of tax, may have the effect of making the taxpayer liable for the High Income Child Benefit Charge,[10] tapered personal allowances,[11] restrictions in the annual allowance for pension savings,[12] and higher student loan repayments. See Annex D, example 3A for an example of the restriction.

3.28 The OTS has been told that this is a poorly understood area. Whilst some guidance is available[13] it does not explain the potential impact above.

Limitation in the reduction

3.29 In some cases not all the finance costs for a particular year can be included in the tax reduction. The reduction normally is the lowest of:

- the finance costs for the year plus any brought forward amount
- the profits of the rental business
- the adjusted total income for year

3.30 The adjusted total income for the year is the net income (the total income after certain reliefs such as loss relief), less savings and dividend income less the personal allowance due.

3.31 This effectively means that interest cannot be used to reduce tax on savings or dividend income and is a particular problem if property is highly geared. See Annex D, example 3B for an example of this.

3.32 Unrelieved finance costs can be carried forward and added to later years' costs for relief, subject to the rules above. However, if the same pattern of income and expenses continue, part of the interest will never be relieved.

Observations on the restriction on finance costs

3.33 The move to a basic rate reduction for finance costs has introduced complexities and the OTS has been told that the rules are not widely understood. In the OTS Survey around half the respondents either had

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[10] Due if adjusted net income (as defined) exceeds £50,000.

[11] Applies if adjusted net income (as defined) exceeds £100,000.

[12] Applies if threshold income (as defined) exceeds £200,000 and adjusted income (as defined) exceeds £240,000.

[13] Tax relief for residential landlords: how it's worked out - GOV.UK (www.gov.uk).

difficulty understanding the rules or used an accountant so that this was not an issue.

3.34 An individual whose non-rental income is savings or dividends may have a different tax outcome to one whose non-rental income is salary or pensions and the policy rationale for this is not clear.

3.35 There is limited tax return guidance in respect of entries needed for UK property,[14] but conversely a more detailed explanation if foreign property is held. It would be helpful if the guidance was clearer and consistent.[15]

3.36 HMRC data indicates that in 2019-20, 266,000 taxpayers had unused relief brought forward compared to the 1,190,000 who declared residential finance costs. This has the potential to increase now that the phasing in of the restriction is complete.

Amount of the loan on which finance costs are eligible for relief

3.37 Relief is given on finance used wholly and exclusively for business purposes.[16]

3.38 It is unclear what the full scope of this is in practice, particularly whether any deduction is allowed for re-mortgaging where the property owner withdraws funds from the property business, provided he or she does not withdraw more than originally invested.

3.39 A long-standing example is reproduced below from HMRC's Business Income Manual (BIM 45700),[17] which applies equally to property income. The example shows that interest on a loan raised to allow the business owner to withdraw capital could qualify for relief, providing the owner's capital account does not become overdrawn as a result. HMRC appears therefore to accept that this comes within the definition of 'wholly and exclusively'.

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14 Self Assessment: UK property (SA105) - GOV.UK (www.gov.uk), see page 12 of UK Property notes (2022).

15 Foreign notes (publishing.service.gov.uk)- see page 10.

16 S34, ITTOIA 2005. Business in this case meaning the UK or overseas property business.

17 BIM 45700 BIM45700 - Specific deductions - interest: Withdrawal of capital from a business - HMRC internal manual - GOV.UK (www.gov.uk).

BIM 45700 states:

A proprietor of a business may withdraw the profits of the business and the capital they have introduced to the business, even though substitute funding then has to be provided by interest bearing loans. The interest payable on the loans is an allowable deduction. This is on the basis that the purpose of the additional borrowing is to provide working capital for the business. There will, though, be an interest restriction if the proprietor's capital account becomes overdrawn, see BIM45705 onwards.

This is followed by several examples of which example 2 is directly relevant.

Example

Mr A owns a flat in central London, which he bought ten years ago for £125,000. He has a mortgage of £80,000 on the property. He has been offered a job in Holland and is moving there to live and work. He intends to come back to the UK at some time. He decides to keep his flat and rent it out while he is away. His London flat now has a market value of £375,000.

The opening balance sheet of his rental business shows:

Mortgage	£80,000	Property at market value	£375,000
Capital account	£295,000		

He renegotiates his mortgage on the flat to convert it to a buy to let mortgage and borrows a further £125,000. He withdraws the £125,000, which he then uses to buy a flat in Rotterdam.

The balance sheet at the end of Year 1 shows:

Mortgage	£205,000	Property at market value	£375,000
Capital account B/F	£295,000		
Less Drawings	£125,000		
C/F	£170,000		

Although he has withdrawn capital from the business, the interest on the mortgage loan is allowable in full because it is funding the transfer of the property to the business at its open market value at the time the business started. The capital account is not overdrawn.

3.41 However, the more general guidance[18] at 'Work out your rental income when you let property' on GOV.UK merely refers to the requirement for the loan to be wholly and exclusively for the letting business, and in particular has the following text:

'Increasing your mortgage

> If you increase your mortgage loan on your buy-to-let property you may be able to treat interest on the additional loan as a revenue expense, or get relief against income tax as long as the additional loan is wholly and exclusively for the purposes of the letting business.
>
> Interest on any additional borrowing above the capital value of the property when it was brought into your letting business is not tax deductible.'

3.42 The OTS has been told of cases where HMRC is not allowing interest in cases where the loan is to finance a withdrawal of capital even though the capital account is not overdrawn.

Recommendation

The OTS recommends that the government improve the existing guidance in relation to mortgaging and re-mortgaging so that it is clearer and more consistent.

Further restrictions if the cash basis is used

3.43 If the cash basis is used there are further restrictions to the amount of the loan eligible for relief.[19] These apply if the total of outstanding loans used wholly and exclusively for business purposes exceed the value of property or properties at the time the property rental business started.

3.44 The policy rationale at the time was that:

'The intended policy outcome of this new section is to limit the amount of interest that can be deducted by those with a property business, where the value of the loans on which they have claimed interest is greater than the value of the properties that they have used in their property business.

This broadly replicates the effect of a review of the capital account currently required when using Generally Accepted Accounting Practice (GAAP).' [20]

3.45 However, it seems that there is an element of double counting in this restriction. Interest costs are already limited by the general wholly and exclusively rule and to add another layer of restriction penalises those on the cash basis, thus discouraging the use of this simplified basis of taxation.

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18 Work out your rental income when you let property - GOV.UK (www.gov.uk).

19 S307C-307D, ITTIOA 2005.

20 Amendments_to_Clause_16_-_Calculation_of_profits_of_trades_and_property_....pdf (publishing.service.gov.uk).

Example 2

Jeremy purchased a buy to let in 2008 for £300,000 using a 100% mortgage. The interest rate is 5% so the total interest cost in 2020-21 was £15,000.

Rents typically covered expenses so Jeremy had some working capital in the business but his property got badly damaged by a storm in December 2021 and he needed to borrow a further £100,000 to repair it. The loan was increased to £400,000 for the last 3 months of the tax year. Loan interest in 2021-22 was therefore £16,250.

If Jeremy is taxed on the accruals basis, these figures form the basis of the income tax reduction, subject to the restrictions outlined above.

If he is taxed on the cash basis, he must compare the total mortgage (£400,000) to the value of the property when the rental began, so £300,000, and restrict the mortgage interest accordingly.

Hence the allowable interest in 2021-22 will be:

300,000/400,000 X £16,250, so £12,187.

Observations

3.46 As mentioned above around half of the respondents to the survey feel they do not understand the rules for allowing finance costs and this restriction, besides its purpose not being clear, adds to the complexity around the matter.

Recommendation

The OTS recommends that the government consider whether the rules for restricting the level of interest relief when the cash basis is used add unnecessary complexity and whether the rules should be consistent with those applying when the accruals basis is used.

Incorporation

3.47 As noted in Chapter 1 there are a range of property ownership structures, one of which is an incorporated business or, put simply, a company. If an individual decides to own property through a company the company would own the property and the individual would own shares in the company and would be likely to also become a director of the company.

3.48 Of the over 3,500 respondents to OTS's survey on property income, the large majority (over 85% of respondents) owned property either individually or jointly (with a spouse, civil partner, or otherwise). Just under 10% owned property through a limited company. Of those survey respondents owning property through a company, in substantially all cases that company was UK incorporated.

3.49 A company is a separate legal entity in its own right and is taxed accordingly. Income and expenses are recorded by the company and Corporation Tax is payable on any net profit. Post-tax profits can either be retained in the company or distributed to shareholders as dividends. Those dividends are subject to Income Tax as explained below.

3.50 A company (via its shareholders and directors) has various legal and administrative obligations, including to make the relevant filings with Companies House and to produce its accounts to certain standards and formats. Its directors also have personal obligations which come with the risk of personal liability for breaches.

Perceived distortions and market view

3.51 As discussed earlier, individuals who are landlords of residential properties are subject to restrictions on the deductibility of interest, unless the property is a furnished holiday letting. The restrictions do not typically apply to companies,[21] whether UK or overseas resident, and this, together with other perceived tax and commercial advantages has resulted in more interest in recent years in holding property through a company.

3.52 Since the announcement of the restrictions in 2015, there has been a considerable amount of market and industry comment. Concerns were raised that highly geared buy-to-let businesses might no longer be commercially viable unless they incorporated.

3.53 One report[22] suggests that in 2021 a record 47,400 new companies were incorporated for buy-to-let businesses – compared to 15,000 incorporations in 2015. These numbers remain small in the context of 2.9 million property businesses owned by individuals.

3.54 However, incorporation is not always the best solution for a taxpayer as the following paragraphs discuss.

Drivers for Incorporation

3.55 In the OTS's Call for Evidence, the following question was asked (under the category of "Structural Aspects":

> 'What prompts landlords to incorporate their property rental businesses and to what extent are such decisions motivated by tax or non-tax reasons?'

Commercial drivers to incorporate

3.56 There were a range of responses to this question. However, most responses - from professional bodies and advisers - indicated that the predominant factors in the decision to incorporate were not purely tax related and instead included:

- the desire for limited liability

[21] There are restrictions under the corporate interest deduction which broadly apply to interest payments of over £2m. Restriction on Corporation Tax relief for interest deductions - GOV.UK (www.gov.uk).

[22] RECORD 47,400 NEW BUY-TO-LET COMPANIES SET UP IN 2021 (hamptons.co.uk).

- factors related to debt including both the access to financing and the ring-fencing thereof
- the ability to exercise control over when income is drawn down, for example the potential to allow the accumulation and reinvestment of rental profits over time
- the desire for flexibility over transfer of ownership of the shares, for example succession planning across generations of a family or over time
- the tolerance for the administrative and compliance obligations and costs associated with a company (including Companies House filings, Annual Tax on Enveloped Dwellings (ATED) compliance and increased accountancy fees)

Tax drivers to incorporate

3.57 Where the OTS heard that the drivers to incorporate were tax-related, it was clear that these primarily related to the restriction on the deductibility of interest costs for individuals.

3.58 Another factor was the rate of Corporation Tax (currently 19%[23]) which is lower than Income Tax (currently 20%, increasing to 40% or 45%[24] for higher rate and additional rate taxpayers respectively).

3.59 This means that if net profits are retained in the company the effective rate of tax on those profits will be lower than if the property were owned personally.

3.60 If post-tax profits are distributed as dividends however, another 'layer' of tax is payable because the individual shareholders will (at 2022-23 rates) pay tax on dividends received at rates of 8.75/33.75/39.35% for basic, higher and additional rate taxpayers respectively.[25] [26]

3.61 The overall effective rate in such cases will depend on the amount of post-tax profits distributed and the Income Tax circumstances, particularly the tax rate band of the shareholder. In practice a small amount of pre-tax profits will be paid as salary. Annex D, example 3C shows the comparison.

3.62 If the shareholders wish to sell the property this could be done in two ways:

- the company could sell the property to the purchaser and pay Corporation Tax on any gain made. If the shareholders wish to access the cash in the company this could be paid to them by way of dividend as discussed above, or if appropriate (for example if the property is the only asset and activities

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23 The Corporation Tax rate is legislated to increase to 25% from 1 April 2023. It was announced on 23 September 2022 that the government would reverse this, but this decision was revoked on 14 October 2022 so that the increase is planned to go ahead. However, under the original proposals a small profits rate of 19% would apply to trading companies and those letting land commercially with profits of less than £50,000 (CTA 2010 s 18N).

24 The government announced on 23 September 2022 that it intends to abolish the 45% rate of income tax from 6 April 2023; however, this announcement was revoked on 3 October 2022.

25 Subject to the £2,000 dividend allowance.

26 These rates have increased by 1.25% from 6 April 2022 in parallel with the introduction of the Health and Social Care Levy. It was announced on 23 September 2022 that the government plan to reverse this increase from 2023-24, however this was revoked on 17 October 2022.

have now ceased) by winding up the company and distributing the proceeds as capital - in which case Capital Gains Tax would be payable by the shareholders on any gain made on the capital distribution

- alternatively the shareholders could sell their shares in the company to the purchaser, in which case Capital Gains Tax at rates up to 20% will be payable by the shareholders on the gain made on the shares

3.63 Therefore, in the same way as where the company pays tax on rental profits and then distributes post-tax profits as dividends there may be two layers of tax to be considered for the sale of a property by the company.

Tax disincentives to incorporate

3.64 Perceived benefits of incorporation were offset by other tax factors which are seen to disincentivise incorporation, primarily:

- the Stamp Duty Land Tax costs of incorporation which were seen as a major barrier given their certainty and immediacy when compared to the possibility of lower tax costs in the future
- the 'second layer' of tax: the Income Tax payable on the withdrawal of net profits from the company as dividends, or the potential for two levels of capital gains where a property is sold

Conclusion

3.65 This chapter has discussed the general principles and taxpayer perception around corporate ownership. Whilst the number of corporate buy to lets has increased and there has been significant publicity around the perceived benefits of using a company to hold property it seems that at present corporate ownership forms a relatively small proportion of overall residential property ownership. It is important that those considering this route are aware of the overall effect of corporate ownership as the OTS has been told that this is not always fully understood.

Chapter 4
Allowances and reliefs

Overview

4.1 There are two reliefs available for those with smaller amounts of income from property. These are the property allowance and Rent a Room relief. This chapter explores how these operate in practice and the interaction between them.

Property allowance

4.2 The property allowance was announced at Budget 2016 and took effect from 6 April 2017 along with a similar trading allowance. They were introduced as a simplification measure to '*make the tax position more certain for micro-entrepreneurs*'.[1] Given the nature of the allowance, HMRC does not have comprehensive data on how many people use it. In our survey around half those responding were not aware of it and less than 8% claimed it.

4.3 The £1,000 allowance means that those with property income of up to £1,000 do not need to declare or pay tax on that income. If the income exceeds £1,000 then the individual can either declare the income and deduct expenses in the usual way, normally on their personal tax return, or claim the £1,000 allowance.

Usefulness of the allowance

4.4 Given the rates of rent in the UK, it is hard to see a significant number of taxpayers who would have annual rental income which totalled less than £1,000. The most likely scenarios would involve letting an unfurnished part of their main residence, such as a parking or storage area (furnished would likely already be covered by Rent a Room relief – see below). The allowance will be much more commonly used as a flat-rate deduction in lieu of actual expenses. HMRC guidance is clear that even if the £1,000 is being claimed taxpayers need to keep a record of their actual expenses; and anyone who is uncertain will check whether the allowance or true expenses give them a better tax outcome, so there will be little genuine simplification.

4.5 Respondents have highlighted a guidance inconsistency with Rent a Room allowance record keeping, and the complexities around the interaction with finance costs (see below). In the light of these challenges and the lack of simplification noted, the government may wish to consider whether this allowance is providing any benefit beyond reducing tax bills.

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[1] Budget 2016 (publishing.service.gov.uk).

4.6 If the allowance is retained, the following points become relevant.

Interaction of property allowance and relief for finance costs

4.7 If the property allowance is claimed, then no basic rate tax reduction for finance costs such as mortgage interest is available. As above, taxpayers may elect not to use the property allowance and instead have a finance cost reduction. In cases where there are unrelieved finance costs from earlier years the guidance setting out the interaction between these and the property allowance is particularly unclear.[2]

Recommendation

> The OTS recommends that the guidance on the interaction between the property allowance and the finance cost reduction is clarified, including illustrative examples, in particular to cover the complex comparison necessary where brought forward reduction relief interacts with the property allowance, where it can be hard for taxpayers to understand what is the best choice for them.

Tax return entries and record keeping requirements

4.8 If the income is less than £1,000 then no entry needs to be made on a tax return. However, guidance requires that full records are kept of this income with the risk of penalties for failing to do so.[3] This is different to the rules which apply to Rent a Room.

Recommendation

> The OTS recommends that HMRC ensure the guidance relating to record keeping for the property allowance is consistent with that for Rent a Room relief and enable a means for taxpayers to confirm the amounts received are below the limits, to avoid risk of penalties.

Rent a Room relief

4.9 Rent a Room relief gives an exemption for income received of up to £7,500 for renting furnished accommodation within someone's own home. It was introduced in 1992 to encourage individuals to make spare capacity in their homes available for rent.

4.10 In 2019-20, 50,000 people had declared Rent a Room income less than the limit and 24,000 claimed the deduction on rents above the limit rather than using their actual expenses, based on data from self-assessment tax returns. However, if Rent a Room income of less than £7,500 is received and the taxpayer has no other reason to file a Self Assessment tax return, there will be no record of this fact, so the numbers using the relief are higher than these

2 PIM4460 - Property allowance: contents: exclusions from relief: residential property finance restriction - HMRC internal manual - GOV.UK (www.gov.uk).

3 Tax-free allowances on property and trading income - GOV.UK (www.gov.uk).

figures reflect. It was noted in the Summary of responses to a government Call for Evidence into Rent a Room relief in 2017[4] that no definitive picture exists of the overall use of the relief.

4.11 In our survey 13.1% of respondents used the relief, with about half of these receiving less than £7,500 of income.

Details

4.12 The exemption applies to income received from letting furnished accommodation in an individual's own home, which must be in the UK. The home must be the individual's only or main residence for all or part of the income period.[5] The exemption does not apply to rooms let as offices or for other business purposes.

4.13 The income limit for exemption is £7,500 (or £3,750 if another individual is jointly entitled to the income).

4.14 This limit applies to the total income from letting the accommodation. This includes both rents and amounts received for goods and services in connection with the rental, such as meals, cleaning and laundry.

4.15 Rent a Room relief can also apply in cases where the income from the letting is taxed as a trade, for example if the letting is a bed and breakfast.

4.16 If the income received is less than the limit it is exempt, although the taxpayer can choose to deduct expenses from income instead, for example if this gives rise to a loss.

4.17 If the income is over the limit then the taxpayer can choose whether to claim the £7,500 exemption and pay tax on the balance or whether to treat the rental as a general rental and deduct expenses in the usual way. The same method does not have to be used each year.

4.18 It is not possible to use the property allowance or trading allowance as well as Rent a Room relief.

Observations

4.19 The OTS has been told that Rent a Room relief is generally well understood and is a valuable relief allowing people to take lodgers to reduce their housing outgoings and meet the policy intention of encouraging the provision of more accommodation.

4.20 The OTS was also told that people use Rent a Room relief as it is more straightforward than recording expenses, even if using the £7,500 relief means that they are paying more tax than they need to.

4.21 The OTS notes the government review into Rent a Room relief in 2017 which concluded that Rent a Room relief was providing an effective incentive for

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4 Rent a room relief: summary of responses (publishing.service.gov.uk).

5 For income taxed as property income this is normally the tax year; for income taxed as trading income this is the basis period for the income.

people with spare rooms to make them available for rent[6] and this was echoed by our respondents.

4.22 Respondents to the review have suggested that the annual exempt amount should be increased. The current £7,500 limit was introduced in April 2016, an increase from £4,250. This matter was considered in the government review in 2017 and it was concluded that no increase was needed at that time.

4.23 The government may wish to consider whether the exemption is set at an appropriate level for the current economy. An increase in line with the CPI increase since September 2015 (the setting date for 2016) would give an exemption of around £8,500.[7]

Does the landlord need to share the property?

4.24 As noted above, the legislation was introduced to encourage people to make spare capacity in their homes available for rent. There is however some confusion over whether the taxpayer needs to be living in the property when the rental takes place, or whether for example the exemption could apply if the taxpayer lets the entire property when he or she is absent on holiday.

4.25 The government review mentioned above noted that the intention of the relief was to incentivise rental of spare rooms and referred to new proposed new legislation requiring shared occupation in order to fall within the Rent a Room scheme. Draft legislation was duly included in the Finance Bill 2018 but this was not enacted[8] (although similar provisions were introduced for Capital Gains Tax).[9]

4.26 As matters stand the position is unclear. The legislation states that the home must be the individual's only or main residence for all or part of the income period,[10] which appears to mean that the taxpayer need not be living in the property when the actual rental takes place, nor does it need to be only part of the property.

4.27 However, GOV.UK guidance states that taxpayers cannot use the scheme if the accommodation is not part of their main home when they let it.[11] This implies that the taxpayer must actually be living in the property at the time and there is no reference to short lettings when the taxpayer is absent.

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6 Rent a Room relief: summary of responses (publishing.service.gov.uk).

7 CPI Sept 2015 was 100.2, Sept 2021 was 112.4 UK historical consumer price index (CPI) - 1988 to 2022. | Inflation Rate and Consumer Price Index (rateinflation.com) or CPI INDEX 00: ALL ITEMS 2015=100 - Office for National Statistics (ons.gov.uk).

8 Income Tax rent-a-room relief - GOV.UK (www.gov.uk).

9 S233B TCGA 1992.

10 S786 ITTIOA 2005 - For income taxed as property income this is normally the tax year; for income taxed as trading income this is the basis period for the income.

11 HS 223 as above. HS223 Rent a Room Scheme (2021) - GOV.UK (www.gov.uk).

Recommendation

> The OTS recommends that HMRC should clarify whether Rent a Room relief applies if the taxpayer is temporarily away from the home – for example where the whole property is let for a short period during sporting events – and to make this clear in guidance.

Tax return reporting

4.28 HMRC guidance[12] states that if income to which Rent a Room relief can apply of less than £7,500 is received then this income is automatically exempt. This is also mentioned in GOV.UK guidance[13] where is it stated that 'The tax exemption is automatic if you earn less than £7,500. This means you do not need to do anything'. It appears therefore that a tax return would not be needed to record this fact. However, if a tax return is prepared for other reasons there is a box on the UK property pages SA 105 to indicate that income within the exemption has been received. This approach adds to complexity and the OTS suggests that there should not be a need to include UK property pages within a return simply to record the exempt income. HMRC data shows that in 2020-21 there were no tax returns completed on this basis, so it seems that the current rules are not widely understood.

4.29 This position is different to that for the property allowance (see above) where although no tax return entries are required for income of less than the allowance, guidance requires that full records of the income are retained.[14] Our recommendation for consistency is included in the property allowance section above.

Conclusion

4.30 Rent a Room is a generally well understood and widely used relief that gives valuable benefits especially at the current time. The OTS does not recommend any major changes to its operation, other than a clarification of guidance and a consideration of increasing the amount of the relief.

12 HS223 Rent a Room Scheme (2021) - GOV.UK (www.gov.uk).

13 Rent a room in your home: The Rent a Room Scheme - GOV.UK (www.gov.uk).

14 Tax-free allowances on property and trading income - GOV.UK (www.gov.uk).

Chapter 5

Treatment of certain expenses

Overview

5.1 This chapter explores some areas of particular complexity for expenses claimed by landlords, including adjustments for the landlord's own use of the property and the difficulties in deciding whether or not costs such as repairs, and the installation and replacement of equipment and fixtures, can be deducted from rental profits.

Private use

5.2 Chapter 2 introduced the starting point that property business profits are calculated on the same basis as trade profits, so a deduction from profits is only available where the expenditure is incurred wholly and exclusively for the purposes of the property business.

5.3 In theory that would mean that any element of private use in a given expenditure would preclude relief entirely. However, the legislation[1] allows a split, with a deduction allowed for the proportion of expense relating to business use and disallowed for the private use element.

5.4 The HMRC guidance is relatively straightforward, but the commonly held view of respondents is that private use adjustments are not calculated consistently. Given the large population of landlords who rent out a second home which they also use themselves, this is a significant issue where there is the capacity for engagement with the public to create guidance which recognises common situations and provides tailored advice.

Recommendation

> The OTS suggests HMRC improve the guidance showing how the adjustments for private use could be made, by way of case study examples for common situations.

Relief for domestic items

5.5 Relief for expenditure on domestic items, such as furniture and non-fitted white goods, for furnished or part-furnished properties can be a complex area involving the need to make various distinctions, such as whether they are replacements or improvements, part of initial costs, or fixtures to the building or not.

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[1] S34(2) ITTOIA 2005, see also Property Income Manual PIM2010.

5.6 Various regimes have tried to address a greater or lesser extent of the complexity over the years, including a renewals basis repealed in 2013 and the wear and tear allowance repealed in April 2016. As noted in previous chapters, capital allowances are not available for fixtures and furniture for use in residential property, unless it is within the furnished holiday lettings regime.

5.7 The pre-April 2016 wear and tear allowance gave a flat deduction of 10% of gross rents (less expenses normally borne by the tenant). It was repealed following an HMRC consultation identifying inequities such as the lack of application to partly furnished lettings and questioning its link to income rather than expenditure.

5.8 The current regime allows relief for the replacement of domestic items,[2] and is closer to the pre-2013 renewals basis. The relief has four conditions:

- a property business is carried on
- expenditure is incurred on the replacement of an existing domestic item with a new one, solely for use by the tenant
- incurred wholly and exclusively for the business, and
- no capital allowances are available for the same expenditure

5.9 This relief means there is no longer a difference in most cases in the treatment of replacement of integrated kitchens and those with free-standing appliances, since the former is typically allowed as a repair and the latter under this relief. See paragraph 5.34 regarding a potential alternative approach to repairs.

Challenges to the regime

5.10 Some level of complexity remains with this regime, which still requires a distinction between improvements and replacement. The amount of relief for a replacement must be reduced by any sale proceeds for the original. Where there is an improvement element, relief is restricted to what would have been a like for like replacement.

5.11 No relief is available for costs of initial acquisitions, unlike capital allowances.

5.12 Many respondents felt that unrepresented taxpayers do not understand the distinction between replacement and improvements, nor why relief for initial costs is not available.

Recommendation

> The OTS suggests HMRC improve the guidance to aid landlords' better understanding of the replacement of domestic items concept with case study examples.

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2 S311A ITTOIA 2005, s250A CTA 2009.

The boundary between improvements and repairs

5.13 Many respondents to the OTS Call for Evidence expressed concerns at the uncertainty with the boundary between repairs and improvements to a property. This issue is particularly problematic for landlords with residential property lettings (other than those within the furnished holiday lettings regime, where capital allowances may be available) as it is only if work done is a repair - with no element of improvement - that the cost is allowable as a deduction from rental profits.

5.14 If however, the work is an improvement the whole of the cost of the work becomes a capital cost with no immediate tax relief (except in very limited cases where it may be possible to claim capital allowances).[3]

5.15 Deciding whether a cost is a repair or an improvement can be difficult and complex, and given the assets concerned (such as property) can involve substantial costs for landlords.

5.16 HMRC give an explanation of this issue in their guidance:[4]

'Repair means the restoration of an asset by replacing subsidiary parts of the whole asset.

An example is the cost of replacing roof tiles blown off by a storm.

There won't be a repair if a significant improvement of the asset beyond its original condition results – that will be capital expenditure. For instance, there will be a capital improvement if the customer takes off the roof and builds on another storey.'

5.17 The example does not address the position if the whole of the roof is replaced but without any significant improvement. This would normally be regarded as a repair as the replacement roof is repairing a 'subsidiary part' of the whole asset (the building). However, the OTS has heard that, because the cost of re-roofing can be substantial, many would regard this as a capital cost and not claim it as a deduction from rental profits.

5.18 Another example would be replacing a fitted kitchen: if the new kitchen is simply a like for like replacement of the old it will be a repair, even if the layout is slightly different.[5] The cost of the whole kitchen will therefore be a deductible expense. However, because the cost of a new kitchen is often a significant amount, the OTS has been told that again many might regard this as a capital cost and not claim it as a deduction from rental profits.

5.19 Where new features are added (for example, if the kitchen were remodelled and extended), then this will be an improvement on the original and the whole cost will be capital and no deduction will be available against rental profits.

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3 Such as where part of the building is not part of the 'dwelling house' (for example the common parts - such as entrance lobby, stairs or lifts - of a building block) CA23060 - Plant and Machinery Allowances (PMA): qualifying expenditure: plant and machinery in dwelling house - HMRC internal manual - GOV.UK (www.gov.uk).

4 PIM2025 - Deductions: repairs: overview - HMRC internal manual - GOV.UK (www.gov.uk).

5 BIM46911 - Specific deductions: repairs and renewals: what is a repair: the 'entirety': examples - HMRC internal manual - GOV.UK (www.gov.uk).

Assets which are fixtures to the building

5.20 The boundary between a repair and an improvement is particularly challenging for assets which are fixtures, as there is a difference in treatment for tax purposes, between an asset which is a fixture and which has therefore become part of the building (such as a central heating system) and an item which is not a fixture, but is an asset in its own right (such as a free-standing fridge).

5.21 Fixtures are defined[6] as being physically fixed to the building and unable to be removed without serious damage to part of that building. The replacement of a fixture will generally be regarded as a repair to the building as a whole. For example, a replacement boiler will generally – with some exceptions[7]- be regarded as a repair (to the building as a whole) and would therefore be an allowable expense for tax purposes.

5.22 Less clear is the position where the work significantly alters or is an improvement on what was previously there. The use of modern materials, often as required by building regulations, may give an apparent element of improvement, but if in reality the work done means the asset can be used as before and does not do a significantly different job, then it is likely to be a repair rather than an improvement.[8]

5.23 An example of this is double glazing. At one time, the replacement of single glazed windows with double glazed was regarded as an improvement to the property. However, over time, double glazing became the industry norm and replacing single with double glazing is now considered as simply a repair to the building, rather than an improvement.

5.24 HMRC have extensive and detailed guidance on the issue of what is a repair in the Property Income Manual[9] and the Business Income Manual.[10] Respondents to the Call for Evidence noted however that the existing guidance is hard for the unrepresented taxpayer to understand and navigate, and many responses to the OTS Survey noted that the rules for allowable and disallowable repair or improvement expenses are unclear.

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6 PIM3210 - Furnished lettings: Replacement of domestic items relief: 2016-17 onwards - HMRC internal manual - GOV.UK (www.gov.uk).

7 In particular the special rules applying to 'integral features' where capital allowances can be claimed (though these do not in general apply to residential properties other than furnished holiday lettings). CA22340 - Plant and Machinery Allowances (PMA): buildings and structures: expenditure on integral features: meaning of 'replacement' expenditure - HMRC internal manual - GOV.UK (www.gov.uk).

8 BIM46925 - Specific deductions: repairs and renewals: what is a repair: changing technology - HMRC internal manual - GOV.UK (www.gov.uk).

9 PIM2020 - Deductions: repairs: contents - HMRC internal manual - GOV.UK (www.gov.uk).

10 BIM46900 - Specific deductions: repairs and renewals: contents - HMRC internal manual - GOV.UK (www.gov.uk).

Recommendation

> The OTS recommends that HMRC should enhance the guidance in respect of the boundary between repairs and improvements to include clear examples of common situations, perhaps using flow-charts to lead towards case-by-case answers.

Energy Performance Certificates

5.25 Energy Performance Certificates (EPCs)[11] were introduced in 2007,[12] as a report that measures the energy efficiency and environmental impact rating of a property. It estimates a property's average energy usage, likely energy costs, and CO_2 emissions. Information on properties with Energy Performance Certificates can be found online.[13] [14]

5.26 The Energy Performance Certificate rating uses a scale from A (best) to G (worst). The report indicates what improvements could potentially be made to improve the score. Most UK residential rental properties must currently have a minimum rating of E.[15]

5.27 Holiday lets are not within these regulations.

5.28 For properties in England and Wales, the Department for Business, Energy and Industrial Strategy (BEIS) is currently considering proposals to increase the minimum Energy Performance Certificate rating to a C for new tenancies by 2025 and for all tenancies by 2028.[16] There will also be a maximum investment cap of £10,000, and landlords would not be expected to invest more than that amount in order to improve their Energy Performance Certificate rating. The regulators in Scotland are also considering this area.[17]

5.29 The purpose of the new measures is to encourage landlords to improve the thermal efficiency of their rented properties, with the aim of reducing energy consumption and tenants' fuel bills and also with consequent improvements to health.

5.30 The measures which can be taken to improve energy efficiency include adding insulation, replacing a boiler, or upgrading single glazed windows with double glazing.[18] For tax purposes some of these measures are likely to be regarded as repairs (such as replacing a boiler), with the cost deductible from rental profits.

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11 Buying or selling your home: Energy Performance Certificates - GOV.UK (www.gov.uk).

12 Housing Act 2004 (legislation.gov.uk).

13 Find an energy certificate - GOV.UK (www.gov.uk).

14 Home (scottishepcregister.org.uk).

15 Domestic private rented property: minimum energy efficiency standard - landlord guidance - GOV.UK (www.gov.uk).

16 Improving the energy performance of privately rented homes - GOV.UK (www.gov.uk).

17 The Energy Efficiency (Private Rented Property) (Scotland) regulations 2020: BRIA - gov.scot (www.gov.scot).

18 EPC for landlords: how to improve EPC rating | Living by HomeServe.

5.31 Others are likely to be improvements to the building (such as installing insulation where none previously existed) and the costs will not be deductible from rental profits. The landlord may therefore need to bear the whole of the cost without any immediate tax relief.

5.32 A 2018 study[19] shows that, of 3.7 million private rented homes in England, roughly 59% were rated band D or below and therefore would be in need of improvement to meet the new regulations. When the Energy Performance Certificates requirements change, this will bring the complexity of the repairs and improvements boundary into sharper focus for many taxpayers and agents. This was a major area of concern for respondents, and it would be helpful if HMRC could dedicate some guidance to this area with examples and a clear view of the boundaries with respect to likely improvements required.

5.33 HMRC already accept that double glazing is simply the modern equivalent of single glazed windows and can therefore be regarded as an allowable repair cost rather than an improvement. Bringing walls, floors and roofs up to current energy requirements could be regarded in the same light.

Proposed wider approach for improvements and repairs

5.34 Given the uncertainties around the boundary between improvements and repairs experienced by unrepresented taxpayers, and in many cases by agents, the OTS has considered whether a different approach could be taken to address this issue.

5.35 This approach would give a deduction from rental profits for most expenditure on work done while the property business is ongoing, irrespective of whether it is a repair or an improvement.

5.36 However work which is part of the initial fit-out of the property after it is purchased (if it is not able to be let until that work is carried out) or which changes the fundamental character of the property - for example an extension which increases the floor area - would be part of the capital cost of the property, with no deduction from rental profits.

5.37 It is likely that the main type of expenditure affected will be for 'fixtures'. These are not covered by replacement of domestic items relief (which specifically excludes fixtures) and often give some element of improvement to the property so may not, under current rules, be an allowable deduction from rental profits.

5.38 Fixtures include items such as kitchens and bathrooms, new solid flooring or, as mentioned above in the Energy Performance Certificate section, costs such as insulation or new types of boilers including heat pumps.

5.39 Costs of this type often need thought as to whether they are straightforward repairs and therefore allowable as a deduction from rental profits, or if the work has a sufficient element of alteration or improvement so that no deduction from profits would be available under current rules.

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[19] Improving the energy performance of privately rented homes: consultation (publishing.service.gov.uk) See table 3, page 12.

5.40 As noted in the previous section, although there is currently detailed HMRC guidance which attempts to clarify the main issues as they currently stand, the OTS has been told that this is still a difficult and subjective decision.

5.41 There is however further HMRC guidance which the OTS believes could be the starting point of a wider approach in deciding whether a cost is an allowable deduction from rental profits and that is to look at whether the character of the property has changed.[20] As this guidance explains:

'A useful test to apply in deciding whether expenditure is on repairs, especially where a lot of work has been done, is to consider whether the character of the asset has changed as a result of the work. **Put simply, you need to ask whether it is the same object before and after the work** [emphasis added].

If after the work the asset simply does the same job as before, then it is a pointer that the work is a repair.'

5.42 Changing the character of the property would include things such as increasing the size of the property for example by adding an extension or by re-configuration of the internal layout such as a loft conversion.

5.43 To give an example of how this would work in practice, currently, if a landlord replaces a kitchen with a significantly improved kitchen (for example, an outdated or basic kitchen is replaced by a more upmarket, fitted kitchen, with additional storage and built in equipment) there is a question mark over whether this is a repair or an improvement for tax purposes.

5.44 However, the character of the property itself has not changed – it is still a house with a useable kitchen (although a much nicer one). The kitchen still has the same function and as there are no structural changes to the property, there would be a case, using the 'character' test, for the whole of the cost to be an allowable deduction from rental profits, despite the apparent element of 'improvement'.

5.45 Under the new approach if, at the same time as the kitchen was replaced, the landlord also built an extension to the property:

- the cost of the kitchen would be an allowable deduction from rental profits, as it is simply replacing one functional kitchen with another
- the extension however would change the character of the property due to the increase in floor area, so the cost of the extension would not be an allowable deduction from rental profits. It is however likely to be an allowable deduction for Capital Gains Tax if or when the property is sold, as it is part of the capital cost of the property

5.46 An allocation of costs between the two elements would need to be made in this situation and thought would need to be given as to whether current legislation allows for reasonable apportionment of costs where appropriate.

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[20] BIM46950 - Specific deductions: repairs and renewals: the character of the asset - HMRC internal manual - GOV.UK (www.gov.uk).

Current HMRC guidance suggests a pragmatic view of apportioning costs could be taken in this type of situation.[21]

Newly acquired properties

5.47 The position may be different where the landlord acquires a new property. In that situation the current guidance[22] is that replacing a kitchen will not be a repair if, when the property is bought it either:

- wasn't in a fit state for letting until repairs carried out or
- the price paid for the property was substantially reduced because of its dilapidated state

5.48 The underlying principle here is that the cost of buying a property in good condition and capable of functioning in a property business is clearly capital expenditure. Hence the cost of buying a dilapidated property together with any additional costs in putting it in satisfactory order so that it is a functioning asset which is capable of being let, is also capital expenditure.

5.49 This principle is consistent with the new approach described above as it is only expenditure which is part of the ongoing property business – rather than the capital cost of acquiring an asset which can be let – which should be an allowable expense for the property business.

5.50 If the property is bought with say, a serviceable but outdated kitchen, but the landlord decides to replace it with a smarter kitchen to make the property more marketable then that would be a repair as for an ongoing property business: the same principle should apply for a newly acquired property. So, provided there is a functioning kitchen when the property is bought and it is in a fit state for the property to be let, the taxpayer does not need to consider whether there was any element of improvement (for example, more cabinets) in the new kitchen in deciding whether the cost is an allowable expense.

Other considerations

Replacement of domestic items

5.51 Although further consideration would need to be given to ensure no inconsistency of treatment, the OTS considers that the current legislation for the replacement of domestic items, as described above, is likely to remain largely unaffected by these new proposals (which in practice would mainly relate to fixtures).

5.52 This is because the relief follows the broad principle that - in a similar way as for the new proposals -the purchase of an asset to set up the letting business is a capital cost, and it is only repairs or replacements to an asset while the property business is running which should be allowable as deductions from rental profits.

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[21] PIM2030 - Deductions: repairs: is it capital? - HMRC internal manual - GOV.UK (www.gov.uk).

[22] PIM2030 - Deductions: repairs: is it capital? - HMRC internal manual - GOV.UK (www.gov.uk).

Capital Gains Tax

5.53 Expenditure on improvements to a property, if they are not allowable deductions from rental profits, may be allowable costs in calculating the capital gain when the property is sold. To prevent duplication of tax reliefs, there are already provisions[23] preventing the cost being brought into the Capital Gains Tax calculation if it has already been allowed as a deduction in calculating rental profits or losses. This would also of course apply for the broader approach to allowable repair and improvement expenditure.

Losses

5.54 Thought would need to be given to the situation where there has been an extensive refurbishment of a property with all the costs being allowable as repairs, whereas previously they would have been improvements for the Capital Gains Tax calculations and added to the capital cost. If the property is sold relatively soon after the refurbishment, there may still be unused rental losses which perhaps mainly reflect what would have previously been costs allowable for Capital Cains Tax.

5.55 The taxpayer could perhaps then elect for the element of losses which related to improvement costs to instead be allowable for Capital Gains Tax purposes. To avoid undue complication this may need to be time limited – for example costs of the two tax years before the sale could be considered in this way.

Challenges

Private use

5.56 As is the case now, there may be situations where a taxpayer deliberately buys a slightly run down property, renovates it, lets it for a fairly short period, getting a deduction from rental income for the various repairs and so on, and then decides to stop letting the property and live in it themselves.

5.57 In that situation, there is no provision for recovering the tax relief already given on the expenditure and the taxpayer therefore effectively gets tax relief for renovating a property which they live in themselves.

5.58 It may be that this type of behaviour would increase if the criteria for deducting repair and improvement costs is widened so that risk would need to be considered.

Consistency with other rental businesses and trades

5.59 The OTS recognises that, should this approach be adopted for landlords of residential property, this could create a divergence of approach for other landlords – for example landlords of commercial property such as shops or offices, or for furnished holiday lettings and also trades more generally.

5.60 Consideration would need to be given as to whether the approach should be adopted more generally or restricted to non-furnished holiday letting residential properties.

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23 BIM15030 - Trade profits: relationship to capital gains tax - HMRC internal manual - GOV.UK (www.gov.uk).

5.61 A divergence of treatment already exists, of course, as commercial property businesses, furnished holiday lettings and trades will often be able to claim capital allowances on this type of expenditure, which would give a broadly equivalent, if not more generous, relief in many cases.

Alternatives

5.62 One suggestion has been that capital allowances could be extended to cover residential properties – currently most of these (except furnished holiday lettings) would not be eligible to claim capital allowances on most of their capital expenditure. However, given the general complexities around the capital allowances regime, the OTS has not explored this possibility in any detail as part of this review, but mentions it to inform wider debate in this area.

Conclusion

5.63 The OTS believes that when considering whether work done to a property constitutes a repair or an improvement to that property, the main test which should be applied is whether the work changes the character of that property – for example whether a room had been added or the floor area increased. If it does not and the property is fundamentally unchanged - although in a better state of repair - the cost is an allowable expense of the property business.

5.64 This would be a more objective definition and would give the taxpayer more clarity and certainty over the treatment of property costs. Expenses such as a better kitchen, upgrading windows, adding insulation to a property, replacing solid flooring or replacing a boiler with a heat pump would be an allowable deduction from rental profits for an ongoing property business, whereas structural work - such as an extension - would not.

5.65 The boundary between capital and revenue costs is not easy to follow and the rules on replacements and improvements are also hard to interpret, particularly as building standards change over time.

Recommendation

The OTS recommends that the government consider introducing a broader immediate Income Tax relief for all property costs – other than where work is part of the capital cost of the building, such as the initial fit-out on properties bought in a dilapidated state or structural work such as extensions to the property.

5.66 This would be simpler for landlords and HMRC to administer and would also support the government's objective in improving the environmental standards of rented property, by offering certainty of tax relief for those costs.

Chapter 6

The furnished holiday lettings regime

Overview

6.1 The furnished holiday lettings (FHL) regime gives certain tax advantages over the wider residential property income rules for short term lets meeting the conditions; mainly relating to the number of days available for, and actually let, each tax year. Although the basis for the furnished holiday lettings regime is the property income rules, it cherry-picks elements of the trading rules such as certain Income Tax and Capital Gains Tax reliefs, and capital allowances.

6.2 HMRC tax return data indicates that there were around 127,000 furnished holiday let businesses owned by individuals using the regime[1] in 2019-20. An important distinction which is not always understood is that the furnished holiday lettings regime does not remove properties entirely from the main property income rules; instead, it alters the application of a selective list of rules, such as the treatment of interest and losses and adds greater access to capital allowances. A UK property in the furnished holiday lettings regime will also, for some purposes, still be part of the taxpayer's single 'UK property business' as discussed in Chapter 2. A particular relevance of this is covered in the section on losses in this chapter.

6.3 It is worth mentioning that the furnished holiday lettings regime also applies to companies. However, the regime is less favourable than that relating to individuals. This chapter relates to individual ownership only.

History and policy objective

6.4 The furnished holiday lettings regime rules were introduced in 1982-83 to provide clarity over whether operating a short term holiday rental business should be treated as a trade for tax purposes, following a number of cases on that subject and the resulting uncertainty for those involved in these businesses.[2] The new legislation did not treat the activity as a trade, but provided that income from it was to be taxed as trading income rather than income from investments. This was important at the time as investment income suffered an additional tax surcharge. Under the original legislation, the day count requirements were lower than they are currently (70 days of actual letting and 140 days availability) and the range of tax reliefs was wider,

1 This is the number of FHL property businesses disclosed to HMRC on Self Assessment tax returns for 2019-20. It may be more than the number of individuals with FHL income, as an individual may have both UK and EEA FHL properties, which would be counted as two businesses.

2 Gittos v Barclay (HM Inspector of Taxes) 55 TC 633.

in particular losses from a furnished holiday let could be set off against general income (sideways loss relief). The property had to be situated in the UK.

6.5 In 2009-10 the regime was extended to properties in the European Economic Area (EEA) to make the rules compliant with EU free movement principles.

6.6 In 2011 and 2012 the rules were tightened, increasing the day count requirements and removing the ability to set furnished holiday lettings losses against general income, or indeed other property income.

The current rules in detail

6.7 In order to qualify as a furnished holiday let, the property must be either in the UK or in an EEA country (the EU, Iceland, Liechtenstein and Norway), and be commercially let to the public as furnished holiday accommodation satisfying various 'period' tests around availability, actual time let, and pattern of occupation, designed in principle to recognise an actively managed short term letting business.[3]

6.8 If the property qualifies it is brought within the furnished holiday lettings regime automatically; it is not possible to 'opt out'.

Tax position of furnished holiday lettings

6.9 If a property qualifies as a furnished holiday let in a particular tax year, then specific tax rules apply to the income and gains from the property. These are:

- interest incurred on borrowings is fully deductible in calculating the taxable profits rather than by giving a tax reduction at basic rate in the way that applies for other rental property
- capital allowances (or a deduction if the cash basis is being used) are given for fixtures, furnishings, white goods and so on within the property; normally no capital allowances are given for expenditure on assets in a residential property. Accordingly, the replacement of domestic items relief does not apply[4]
- income from the letting can be treated as relevant earnings for the purpose of calculating what level of pension contributions can be made
- losses from the letting can only be set off against profits from furnished holiday lettings (FHL) rather than more general property income. Losses from a UK FHL business and those from an EEA FHL property business are treated separately, so that a loss in one cannot be set off against a profit in another
- income from a furnished holiday letting held jointly by married couples or civil partners is not by default split 50:50 for Income Tax purposes.[5] HMRC guidance states that such income can instead be split as the couple decide.[6]

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3 See the 'Occupancy conditions' in HS253 Furnished holiday lettings (2021) - GOV.UK (www.gov.uk).

4 See paragraphs 5.5 few following.

5 See paragraphs 3.9 few following.

6 PIM1030 - Introduction: jointly owned property & partnerships - HMRC internal manual - GOV.UK (www.gov.uk) and TSEM9820 - Property held jointly by married couples or civil partners: The 50/50 rule: Income from furnished holiday lettings.

Any such split however must be justifiable, for example based on the actual interests the couple hold in the property, or the respective amounts of work undertaken by each individual

- various Capital Gains Tax reliefs also apply. The property is treated as a trading asset for the purposes of:
  - Business Asset Disposal Relief, which means that a gain on the sale of a property qualifying as a furnished holiday let (FHL) can be taxed at 10% rather than 28% (or 18% for a basic rate taxpayer), providing the gain is covered by the taxpayer's lifetime Business Asset Disposal Relief limit,[7] which is currently £1m. In 2019-20 2,000 taxpayers holding furnished holiday lettings claimed Business Asset Disposal Relief totalling gains of £366m, reflecting a tax saving of between £30m and £65m[8]
  - Business Asset Rollover Relief, which means that a gain made on the sale of an FHL property can be deferred if the proceeds are reinvested in a suitable asset - typically a new FHL property
  - Gift Hold-Over Relief, which means a gain made on gifting an FHL property can be held over
  - loans to traders, which means that relief is given if a loan is made to an FHL business which proves irrecoverable
  - substantial shareholding exemption (which applies to companies only)

Property which does not meet all the conditions

6.10 There are some further rules which assist taxpayers if the property or properties do not meet all the conditions for a particular year. This is to help continuity and avoid taxpayers needing to consider the consequences of failing to qualify for short periods. These rules aim to allow taxpayers affected by uncontrollable circumstances to remain in the furnished holiday lettings regime for up to two further tax years, and are helpful, as a change in the status of the property can cause tax complexities.

6.11 There are two elections which can be made where properties would otherwise fall short of the requirements for the regime:

- the averaging election, which allows the day counts to be considered across the property portfolio, potentially bringing in some properties that might otherwise not meet the requirement
- the period of grace election, which allows up to two years of failing to meet the conditions before the properties fall out of the regime

6.12 See Annex D, examples 6A, 6B and 6C for further details and examples showing how the elections operate.

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[7] Business Asset Disposal Relief can apply to gains made on certain business assets, including gains on disposals of FHL properties. Each taxpayer has an overall lifetime limit of £1m to apply to all such gains.

[8] The data has been adjusted to account for the reduction in the lifetime limit from £10m to £1m in 2020. The figures given relate to the claims in 2019-20 that would have still been valid under the new lifetime limit of £1m.

What if a property ceases to qualify as a furnished holiday let?

6.13 If a property does not meet the conditions to qualify as a furnished holiday let (FHL) despite the averaging and period of grace elections, then in future years or until it qualifies as an FHL again the profits will be taxed as those of a general rental business[9] and none of the special rules for FHLs will apply.

6.14 In particular, if capital allowances have been claimed, the market value of all the assets on which allowances have been claimed needs to be compared with the tax written down value (typically zero due to the availability of the annual investment allowance unless the business is very large) and tax charged on the difference.

6.15 Similar adjustments would be needed if the property is taxed on the cash basis. The market value of assets on which a deduction has been claimed instead of capital allowances must be included in the profits of the final FHL year.

6.16 As losses from an FHL business can only be set against other FHL profits (UK and EEA FHL businesses being treated separately for these purposes) any accumulated losses may be lost if the property loses its FHL status.

Interest relief

6.17 The rules which restrict interest relief to a basic rate tax reduction do not apply to furnished holiday lets, so a full deduction is available on the allowable finance costs. Annex D, example 3A shows the difference between a full deduction and a basic rate reduction.

6.18 There has been an increase of nearly 18% in the number of furnished holiday lettings businesses owned by individuals between 2016-17 and 2019-20, and this may partly be due to the change in the interest rules.

Joint ownership

6.19 The rules relating to spouses and civil partners who jointly own property (which require the income to be by default split between them 50:50) do not apply to income from furnished holiday lets. Therefore, income would normally be split based on the interest each spouse has in the property. However HMRC guidance as noted above confirms that the couple may agree a different split. Any such split however must be justifiable, for example based on the actual interests the couple hold in the property, or the respective amounts of work undertaken by each individual.

6.20 Respondents to our consultation also highlighted that the settlements legislation may apply a different split of income for tax purposes.

6.21 There seems no reason why different rules should apply for furnished holiday lets and general letting businesses and the OTS has learnt from respondents to the OTS Call for Evidence and Survey that this whole area is poorly understood and leads to confusion.

6.22 The OTS has recommended that the government should consider removing the 50:50 rule for spouses and civil partners and aligning treatment to other joint owners and to the position for spouses under Capital Gains Tax and

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[9] See Chapter 2.

Inheritance Tax. To prevent abuse, the default beneficial ownership position should not be capable of being displaced. If this recommendation is followed the same rules (beneficial ownership) would apply for both general and furnished holiday let properties owned by spouses and the confusion outlined above would fall away.

6.23 This would also mean that the choice around using the cash basis for spouses owning rental properties 50:50[10] would be the same whether the property was a general letting or a furnished holiday let.

Losses

Using losses from furnished holiday lets

6.24 Losses from a furnished holiday letting (FHL) can only be set off against profits from FHL lettings in the same or future years. They cannot be set off against general property income. UK FHLs and EEA FHLs are treated separately, so that a loss in one cannot be set off against a profit in another.

6.25 If the nature of the furnished holiday lettings business changes, so that it no longer meets the criteria, then losses from the former furnished holiday lettings business cannot be carried forward against profits from a general letting business – even if the profits are generated from exactly the same property. This could happen if the owner of the property decides they no longer wish to continue their furnished holiday lettings business and decides to let it on longer term lets for more stability of income. The OTS has been told that, in view of the effects of the pandemic, this may not be an uncommon situation and could affect many owners of furnished holiday lettings, both in the UK and the EEA.

6.26 It would therefore be helpful if losses from a discontinued furnished holiday lettings business could be carried forward and used against profits from the same property.

6.27 There could also be a situation where property did not meet the furnished holiday letting (FHL) tests for several years and so was let as a general letting, but then once again qualified as an FHL. It is clear that the FHL losses cannot be carried forward against the general letting business profits, but not clear whether these losses could be used again when the property re-qualified.

Setting general letting losses against furnished holiday lettings profits

6.28 The furnished holiday lettings regime creates a selective list of instances where different rules apply to the income and expenses, such as treating losses as described above. Because there are no provisions to the contrary, an overall profit from UK furnished holiday letting properties will be aggregated into the overall results of the single UK property business, meaning that it can be reduced by any overall 'loss' arising from the remainder of the UK property business. The situation is the same when considering furnished EEA properties aggregated into the results for the single 'overseas property business'.

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10 See paragraphs 3.16 few following for an explanation of how the cash basis applies when properties are owned jointly by spouses.

6.29 The position is the same with general property losses brought forward, as they are set against any profits of the one property business and nothing specifically precludes that including the profits of furnished holiday lettings.

6.30 The legislation and guidance around this are felt by many commentators to be unclear. Many know it is possible to 'off-set losses' in this way (including general property losses brought forward), as it is implied in the notes to the Self Assessment tax return UK property pages,[11] but do not necessarily understand why or feel they can identify where the law allows it.

6.31 Adding to the confusion, there is no specific entry in the UK property pages to enable that loss off-set or step through the details of what has happened, and instead the instruction is to treat the general lettings loss as if it were a brought forward furnished holiday lettings loss.

6.32 The OTS has been told that this is not widely understood amongst taxpayers and that the streaming of losses adds to the complexity of the regime. It would be helpful if the guidance and reporting in respect of this matter could be clarified.

Capital allowances

6.33 If the furnished holiday lettings (FHL) regime is used, then capital allowances (or a deduction if the cash basis is used) can normally be claimed on fixtures, furnishings and white goods in the property. If capital allowances are claimed the annual investment allowance (AIA) provides a full deduction for qualifying expenditure of up to (currently) £1m per annum. If the cash basis is used a full deduction can be claimed on qualifying expenditure, giving broadly the same effect.

6.34 This is different to the rules applying for general residential lettings where capital allowances are not available but relief is given for the replacement of domestic items (see Chapter 5). Broadly therefore those with FHL properties receive a tax deduction for the initial costs of such items but those undertaking a general letting only get relief when items are replaced.

6.35 The OTS has been told that this is a valued part of the regime, but has also been told that in some cases capital allowances are not received on the full expenditure as it tends to be incurred in the same period that the rental starts and the property may not be let sufficiently in the first year to achieve FHL status. In such cases capital allowances will be based on the market value of the assets when the property first qualifies as a furnished holiday let, which is likely to be lower than the full expenditure incurred, or the actual expenditure if this is lower than market value.[12]

VAT

6.36 Whilst the provision of domestic accommodation is exempt from VAT, the provision of holiday accommodation (defined for the purposes of VAT as any accommodation advertised or held out as suitable for holiday or leisure use) is

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[11] Self Assessment: UK property (SA105) - GOV.UK (www.gov.uk) see pages 6 and 11 of the UK property notes (2022).

[12] S13B CAA 2001.

standard rated for VAT.[13] All owners of such holiday accommodation, whether or not within the FHL regime, should register for VAT and charge VAT at the standard rate of 20% if turnover exceeds £85,000. A temporary reduced rate applied from 15 July 2020 until 31 March 2022.[14]

6.37 The definition of holiday accommodation for VAT purposes is not the same as the definition of a furnished holiday let (FHL) for Income Tax and so VAT may apply to a general holiday letting even if it doesn't qualify as an FHL.

6.38 In practice this is unlikely to affect many who only provide furnished holiday lets, as the turnover threshold is unlikely to reached.[15] However, if for example, the landlord is a sole proprietor who owns a VAT registered business unconnected to the FHL, then VAT will also need to be charged on holiday accommodation, as VAT registration covers all activities under the same legal entity.

6.39 The OTS has found that this point is not widely recognised and is not mentioned on GOV.UK general tax guidance.[16] It would be helpful if there was a cross referral to the VAT position on such activity.

Interactions with business rates

6.40 A significant number of respondents noted that the day count tests for furnished holiday lettings are not the same as the test applying for business rates purposes, which themselves differ between England, Wales, and Scotland:

- in England a property will be rated as a self-catering property so that business rates apply if it is available to let for short periods totalling 140 days or more per year. From 1 April 2023 there is an additional requirement that the property must be actually let for 70 days
- at present properties in Wales must be available for 140 days and actually let for 70 days but from 1 April 2023 these limits will increase to 252 days and 182 days respectively
- properties in Scotland must be available for 140 days and, from 1 April 2022 actually let for 70 days

6.41 Whilst business rates are outside the scope of this report, the OTS should reflect the strong sense of confusion expressed by respondents that different tests apply for different purposes. It may be helpful for the respective guidance pages to each draw this distinction and provide links to one another.

Is the furnished holiday lettings regime needed?

6.42 The regime can give valuable tax benefits but is not widely used and adds a complex layer to the tax rules which apply to property income. In 2019-20

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13 Hotels and holiday accommodation (VAT Notice 709/3) - GOV.UK (www.gov.uk).

14 Introduction of a new reduced rate of VAT for hospitality, holiday accommodation and attractions - GOV.UK (www.gov.uk).

15 The average number of properties owned per landlord in 2019-20 (both general and FHL properties) was 1.89.

16 Renting out your property: Paying tax and National Insurance - GOV.UK (www.gov.uk).

there were around 2.8 million UK property businesses owned by individuals and 83,000 overseas property businesses owned by individuals, but only around 127,000 of the total of around 2.9 million were in the furnished holiday lettings regime, 111,000 in the UK and 17,000 in the EEA.[17]

6.43 The OTS Call for Evidence and Survey showed a variety of landlords benefitting from the regime. The widely held view of respondents was that the regime covers a relatively small core of people running a substantial short term letting business, and a long tail of second-home owners renting one property. This is borne out by the results of our Survey which ranged from individuals owning one property (around two-thirds) with many of those (40%) also making personal use of the property, to those operating 'holiday complexes' with a number of self-catering cottages and activities. Only 8% of respondents to the Survey owned 4 or more properties within the regime. The activities of those in the latter category might be considered to be closer to trading than to property investment, as discussed in Chapter 2.

6.44 Respondents in general were neutral on the benefits of the regime compared to its administration, and those who were positive felt the scope was too wide.

6.45 The existence of the regime may distort behaviours; the OTS was told that the abolition of full mortgage interest relief has led to some landlords moving to the furnished holiday lettings regime where mortgage interest is fully allowable. Others will find the regime desirable as a result of the Capital Gains Tax reliefs, particularly Business Asset Disposal Relief which can mean a 10% rate of Capital Gains Tax when the property is sold. The existence of the regime may incentivise those who purchase what is fundamentally a holiday home to rent it out sufficiently to meet the requirements of the regime so that they can benefit from the reliefs available whilst using it personally as much as possible.

6.46 There are also more social arguments against retaining the regime. The OTS has heard arguments that it has a detrimental effect on the stock of housing in coastal and other holiday regions and whether the relief should apply to second homeowners whose motivation in buying the property was for a holiday home, but who rent for the minimum period to cover costs and access the tax reliefs available. But the OTS has also heard counter arguments that the regime encourages holiday lettings and hence UK tourism.

6.47 The OTS also acknowledges the abolition of the regime may mean that more taxpayers argue that a letting business where a high level of services are provided should be treated as a trade, as was the case before the regime was introduced.

[17] This is the number of property businesses of each type disclosed to HMRC on Self Assessment tax returns for 2019-20. It may be more than the number of individuals with property rental income as an individual may have both UK and foreign properties which would be counted as two businesses.

Recommendation

> The OTS recommends that the government consider whether there is continuing benefit to the UK in having a separate tax regime for furnished holiday lettings.

Brightline test for trading status

6.48 If the furnished holiday lettings regime is abolished, the government may wish to consider means of making the boundary between trading and non-trading more certain. One possibility could be the introduction of a statutory 'brightline' test[18] to provide a clear test for when property letting activities subject to Income Tax would qualify as a trade.

6.49 Respondents to the OTS were of the view that a distinction was necessary between income motive with a high level of management, as opposed to an investment gain motive likely to be sought from, say, a second homeowner.

6.50 Possible factors that could be considered within a brightline test are:

- minimum number of properties let:
  - the OTS suggests trading status cannot apply where fewer than a certain number of units are let, for example in the range of 5 to 10 properties.
- letting is on a short term basis:
  - there already exists a definition of short term letting[19] within the furnished holiday lettings legislation, which could be used for this purpose
- no personal use of the property let:
  - the OTS considers this condition should be introduced to distinguish the landlord with profit motive from an investor in property. Limited occupation for maintenance etc should be allowed
- level of personal time devoted to the property letting and services provided:
  - the OTS acknowledges the difficulty in judging whether services are of a non-investment nature and looks instead at the provision of personal labour in the letting operation. For example, a minimum level of hours per week could be necessary where devoted by the proprietor, or a higher value where provided by employees/agents

6.51 The OTS also notes that there have been difficulties in establishing whether a business is eligible for Business Relief (Business Property Relief) for Inheritance Tax and Incorporation Relief for Capital Gains Tax. There have been a number of tax cases on these matters. If the government takes forward the OTS's suggestion of a statutory brightline property trading test for Income Tax set

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[18] A clearly defined rule or standard that uses objective points to avoid ambiguity.

[19] S325 ITTOIA 2005: Not more than 31 days in the same continuous occupation, apart from 155 days in the year.

out above, it is suggested that the definitions for Inheritance Tax, Capital Gains Tax and National Insurance are aligned to the Income Tax status.

Recommendation

> If the furnished holiday lettings regime is abolished the OTS recommends that the government consider whether certain property letting activities subject to Income Tax should be treated as trading and whether it would be appropriate to introduce a statutory 'brightline' test to define when a property trading business is being carried on.

Should the furnished holiday lettings regime be better targeted?

EEA properties

6.52 Properties in the European Economic Area (EEA) can also be treated as furnished holiday lettings (FHL) under the same conditions as for UK properties. In the 2019-20 tax year, out of a total number of around 127,000 FHL businesses owned by individuals around 17,000 of these had properties situated in EEA countries. Answers to the OTS Survey showed only 3% of the respondents held FHL properties overseas.

6.53 Reporting income from FHLs in the EEA is confusing, as the income must be included on a separate UK property page (SA105) rather than on the foreign pages (SA106) where general foreign rental income is shown.

6.54 Given that the UK is no longer in the EU, including just EEA properties within the regime (rather than either limiting the regime to include UK properties only or extending it to include properties throughout the whole world) appears to be a distortion.

Changing the tests

6.55 If the government conclude that the regime should be retained the OTS has considered the current tests.

6.56 The current day count requirements of 105 days actually let and 210 days availability are generally thought to be reasonable having regard to the letting season in the UK, although the OTS has been told that these limits are hard to meet in areas with a short rental season.

6.57 The OTS has considered whether a differently targeted test might be more appropriate for the relief. The policy rationale for introducing the furnished holiday lettings regime was to provide certainty following a number of cases where those letting short term holiday accommodation were contending that they were in fact carrying on a trade. The furnished holiday lettings regime accordingly provided a 'bridge' between trading and property investment for such circumstances. When it was originally introduced the FHL regime was very similar to the trading regime, although some reliefs were abolished in 2010.

6.58 If the policy objective of the FHL regime is still to give relief for ventures that are similar to a trade it may be that retaining the 'availability condition', but abolishing the 'occupation condition', and restricting private use to a minimum amount would be a more appropriate test.

6.59 Of the 111,000 UK FHL businesses owned by individuals in 2019-20, some 10% recorded private use in their tax returns. For the 17,000 EEA FHL businesses, approximately 18% had some element of private use.

6.60 Not requiring a specific number of days of occupancy would assist those who, despite marketing efforts do not manage to meet the occupancy test. Requiring instead that private use be kept to a minimum level would also mean that those who aim to use their property as much as possible whilst still meeting the current availability and occupancy conditions will cease to be eligible for the FHL regime. This will have the effect that the regime is more closely targeted to those who are running the venture as a business.

6.61 The OTS was told by respondents that people who are really seeking to make a profit from their property venture do not occupy it personally as they would always rent to a paying customer if possible.

6.62 It may be harder to ensure compliance with a test based on minimum private use rather than actual rented occupancy, although many holiday rentals are through an agent and private use has to be booked and recorded, so in many cases there will be records to back up Self Assessment filings.

6.63 If the regime is retained, removing any material private use element would tighten the requirements for the regime, such that it would not apply to second homes, and make the definition of the regime significantly easier, potentially by removing some day counting.

Transitional issues to consider if changes were made to the furnished holiday lettings regime

6.64 If changes were made to the regime (whether it was abolished or more closely targeted) the government may wish to consider whether there should be any transitional rules (acknowledging that this adds to complexity).

6.65 Consideration should be given to:

- the treatment of assets on which capital allowances have been claimed. At present, if a property ceases to be within the regime all such assets are treated as sold at market value and a balancing charge[20] may arise. Assets outside the regime may qualify for tax relief as replacements, although some will not qualify. Applying a full balancing charge might not be appropriate in all cases. Consideration might also be given to allowing individuals to elect for limited spreading of balancing charges

- the treatment of losses. Losses from furnished holiday lettings properties cannot be set against profits from general lettings. It may be appropriate

[20] Capital allowances and balancing charges (Self Assessment helpsheet HS252) - GOV.UK (www.gov.uk).

to merge all or part of these losses with other rental losses, after dealing with balancing charges

- the Capital Gains Tax provisions. General policy on changes to Capital Gains Tax has been that the new rules apply to disposals after the commencement date. However, the current Business Asset Disposal Relief rules do allow disposals to be made within three years of a qualifying business ending, and the government may wish to consider whether this should be retained in circumstances where the FHL regime ceases

Recommendations

Should the government conclude that the furnished holiday lettings regime be retained, the OTS recommends that the government then consider:

- removing the current distortion of allowing the regime for properties in the European Economic Area, either by permitting worldwide properties to qualify, or by limiting the regime to UK properties
- restricting the regime to properties used for commercial letting by removing the potential for personal occupation. This would permit a simpler approach to defining the regime.

The government should consider:

- providing clear guidance and improving the tax return form to show how non-furnished holiday letting losses can be set off against furnished holiday lettings profits, with case study examples
- undertaking a review of each set of guidance on day count rules for furnished holiday lettings to ensure all refer to the different rules for business rates purposes in the various parts of the UK

Chapter 7
Making Tax Digital for Income Tax

Making Tax Digital for Income Tax

7.1 Making Tax Digital (MTD) for Income Tax is a new digital reporting regime, scheduled to start on 6 April 2024.

7.2 From that date self-employed individuals and landlords who meet the relevant criteria (broadly an annual combined turnover of £10,000) will need to keep records digitally and – using MTD for Income Tax compatible software - file online quarterly updates of their business income and expenses with HMRC. The use of MTD for Income Tax-specific accounting software is encouraged, although it will remain possible for individuals to use spreadsheets (or non-compatible accounting software), together with suitable MTD for Income Tax bridging software, to file updates with HMRC.

7.3 HMRC expects there to be 4.2m taxpayers affected.[1] This includes around 1 million landlords whose property income turnover meets the £10,000 threshold, plus about 380,000 landlords who are also self-employed, where the combined turnover for both business types meets the £10,000 threshold.

7.4 MTD for Income Tax is a central part of the government's ambition for HMRC to become one of the most digitally advanced tax authorities in the world and provide a modern digital service for taxpayers.[2] Other key objectives are to require the use of digital record keeping and reporting to help reduce taxpayer error and to support business productivity by encouraging the digitalization of business administration. These, together with more HMRC interaction with the taxpayer, and guidance given though digital prompts and nudges, are expected to contribute to a reduction in the tax gap.[3]

7.5 The Public Accounts Committee[4] has expressed concern on the impact MTD for Income Tax will have on taxpayers with relatively simple affairs - for example a retired person with one rental property - and whether the necessary technology is at a sufficiently advanced stage to support the reporting process.

7.6 In responses to the Call for Evidence, the online Survey and in meetings with stakeholders, the OTS has found that MTD for Income Tax is a common area

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[1] Extension of Making Tax Digital for Income Tax Self-Assessment to Businesses and Landlords - GOV.UK (www.gov.uk).

[2] Making Tax Digital: An evaluation of the VAT service and update on the Income Tax Service (publishing.service.gov.uk).

[3] Extension of Making Tax Digital for Income Tax Self-Assessment to Businesses and Landlords - GOV.UK (www.gov.uk).

[4] HMRC Annual Accounts 2020-21 (parliament.uk).

of concern across all these respondents, particularly around awareness of the obligation, the potential additional burdens, and the uncertainty of the process. This chapter reflects that concern and recommendations which were discussed with respondents.

What is it?

7.7 Currently, taxpayers with an Income Tax liability to report will submit a Self Assessment tax return annually, normally by 31 January following the end of the tax year.[5]

7.8 Instead of submitting one annual return, those in scope of MTD for Income Tax will need to keep their business records digitally and file the following with HMRC:

- quarterly digital updates of their business income and expenses, and
- an annual report ('end of period statement') for each business type, summarising the quarterly data and making any tax adjustments, and
- a Self Assessment tax return equivalent ('final declaration') including the information from the annual reports together with details of their other income (for example, employment or pension income, bank interest and so on) and also claiming reliefs, such as pension contributions

7.9 As the OTS explained in the 'Tax year end date report' published in September 2021 a taxpayer with a property business who is also self-employed will have 11 separate filings for a tax year, instead of the current single annual filing.[6]

7.10 Respondents to the OTS Call for Evidence were very clear in their opinion that the main additional burdens for taxpayers of MTD for Income Tax will be the administration of quarterly updates and any accompanying IT requirements necessary to adapt their current business practices, including MTD for Income Tax compatible software. HMRC has estimated[7] that both of these are likely involve significant additional costs for the taxpayer, although HMRC notes that some businesses may be able to use free software.

7.11 As outlined above, these new provisions will be in place for all taxpayers (those who fall within the MTD for Income Tax criteria) for accounting periods starting on or after 6 April 2024 - so the first filing obligation will be for the quarter 6 April 2024 to 5 July 2024. Taxpayers can choose to sign up earlier through the pilot (explained in more detail below) although the eligibility criteria for this is currently very narrow with very few individuals joining.

7.12 Some businesses - such as partnerships – will have a delayed start: the date for this has recently been confirmed as 6 April 2025 for those with just individuals as partners.[8] The date for more complex partnerships is yet to be confirmed and the OTS has been told there may be no benefit in introducing MTD for such large businesses. Those who are 'digitally excluded' and unable

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5 Taxpayers who choose to file a paper return also file this with HMRC on an annual basis, by 31 October following the end of the tax year.

6 Tax year end date report (publishing.service.gov.uk).

7 Making Tax Digital for business - GOV.UK (www.gov.uk).

8 Check when to sign up for Making Tax Digital for Income Tax - GOV.UK (www.gov.uk).

to use IT for any reason, perhaps due to their age, religion or a disability, will be able to opt out of MTD for Income Tax, but HMRC envisage that this population will be small.

Practical concerns

7.13 The OTS has heard several significant concerns which could impact the effective adoption of MTD for Income Tax both for landlords and also for self-employed individuals.

7.14 Outlined below some of the main areas which the OTS has been told will be particularly problematic for landlords:

Threshold

7.15 The OTS has been told on numerous occasions that the threshold of £10,000 is too low, for landlords in particular - certainly for the commencement of MTD for Income Tax and potentially in the longer term as well.

7.16 The evidence suggests that a landlord with such low gross rentals will have a modest taxable profit, if any. This type of landlord is likely to have just one property and typically will keep either paper records, or a simple spreadsheet. The step-up costs of adopting MTD for Income Tax will bear more heavily at this level and are disproportionate for the business' needs. HMRC have already indicated that three-line accounts (rents, costs and net profit/loss) will be sufficient for MTD for Income Tax where turnover for the business is less than £85,000, which seems to indicate limited value of the data.

7.17 The OTS acknowledges that, although there would be an Exchequer impact on raising the threshold, this could be outweighed by lower customer costs, higher levels of compliance and better taxpayer and agent engagement.

Multiple agents

7.18 The MTD for Income Tax process is broken down into four main elements: digital record keeping, quarterly updates, end of period statements, and the final declaration. The need for multiple agent access was one of the highest priority calls from respondents.

7.19 Digital record keeping and quarterly updates are bookkeeping processes. It is likely that some taxpayers will use bookkeepers, letting agents or other professionals to complete digital records and file the quarterly updates. Many agents responding to the Call for Evidence were planning to outsource MTD quarterly filing to bookkeepers, for cost and time reasons.

7.20 It is therefore likely that many taxpayers will have at least two agents dealing with different aspects of the overall process, and potentially more if they have more than one stream of business income - for example landlords with properties in joint ownership with different co-owners, or landlords who are also self-employed.

7.21 It will be important for HMRC that only properly authorised agents should file any tax return on behalf of their clients and this includes the MTD for Income Tax updates. HMRC will need to make sure that its systems are only accessed by properly authorised agents - access by the agent using the taxpayer's own access credentials would not be acceptable.

7.22 All MTD for Income Tax filings made by agents are done (or will be done) through the HMRC agent services account. The agent services account, however, only enables one agent to act for a taxpayer for the MTD for Income Tax service at any one time. It is not currently possible to have two different agents – for example a bookkeeper filing quarterly updates and a tax adviser filing the end of period statement and final declaration - filing under the same service for the same taxpayer.

7.23 The single agent concept is a fundamental part of the way agent access is built into the agent services account; this applies not only to MTD for Income Tax, but also to other services such as the 60-day UK property return service and MTD for VAT.

7.24 The OTS notes that HMRC have been aware of the need to accommodate multiple agents for more than a decade. It has always been easier to accommodate multiple agents outside digital systems. MTD for Income Tax has brought the issue of multiple agents to the fore, since for many taxpayers there will need to be two or more agents authorised to file digital returns with HMRC in respect of the same tax and same tax year.

7.25 The OTS shares the disappointment of respondents that multiple agent authorisation has not yet been built into the new systems to support MTD for Income Tax. It is also worth noting that MTD for Income Tax may introduce a new concept of a record keeping or filing agent, who may not have the same training, qualifications or responsibilities as tax agents. Different standards[9] will be appropriate for those purely keeping digital records and filing quarterly updates.

7.26 The use of multiple agents also brings uncertainty on responsibility for the accuracy of the quarterly updates and the end of period statements. Although the taxpayer remains ultimately responsible for ensuring filings are on time, each filing obligation throughout the MTD for Income Tax process creates a potential trigger for penalty points and charges. Guidance for agents on areas of responsibility where more than one agent is involved would be welcomed.

Jointly owned property

7.27 Separate quarterly updates and end of period statements are required for each UK property business and each overseas property business. Within each of these business types, a taxpayer may own one or more properties and own them in different ways. For example, taxpayers may have sole ownership of some properties and joint ownership of others. For the 2019-20 tax year, of the 2.9 million property business owned by individuals almost half related to landlords with jointly owned property.[10]

7.28 The position for jointly owned properties makes MTD for Income Tax much more complicated for many landlords than the obligations for self-employed traders. If there are two or more owners of a trade that is usually a partnership. The partnership will be the entity that keeps records digitally and files quarterly

9 HMRC has published standards for tax agents HMRC: the standard for agents - GOV.UK (www.gov.uk).

10 HMRC stats.

updates, providing summary figures to partners. The OTS notes that HMRC have deferred the start date of MTD for Income Tax for partnerships.

7.29 At present, taxpayers with a jointly owned property are able to indicate on the Self Assessment tax return which owner keeps the underlying records and are required to provide the name and address of the record keeper. If the taxpayer is not the record keeper, they simply need to record the overall profit or loss in their tax return from information given to them by the record keeper: full details of income and expenses are not needed.

7.30 In this way, records are able to be kept on a property-by-property basis and the results are then split by the record keeper and advised to the co-owner(s). This prevents duplication of effort by the joint owners and also ensures a consistency of record keeping. Taxpayers who have a jointly owned property are still personally responsible for the accuracy of their own tax returns but current guidance is clear that they do not need to report full details if they are not themselves the record keeper.[11]

7.31 This is similar in concept to a partnership which has a 'nominated partner' who is responsible for managing the partnership's tax return and keeping business records.[12]

7.32 Respondents hoped that this structure could be retained for MTD for Income Tax. However, to date HMRC have set out that each taxpayer has individual responsibility for their MTD for Income Tax filing obligations including filing quarterly updates on an individual basis. This will be problematic for jointly owned properties, where there will be a single set of underlying records. Splitting records at that level will be confusing and likely to lead to error, rather than reducing error.

7.33 One option would be for the updates to be filed for the property which would then be split within the HMRC system and the correct shares allocated to the taxpayers. Alternatively, the split could be achieved at taxpayer level if appropriate commercial software is available. However the latter would be complex to achieve in practice and it is not clear whether such software would be able to also deal with MTD filings for all joint owners, particularly those with complex affairs.

7.34 The position becomes more complicated where a taxpayer owns more than one joint property, and the other joint owners of each property are different individuals. The taxpayer will then have multiple joint properties to report with the digital records held by different record keepers.

7.35 The record keeping may also be done in different ways, for example one record keeper may use spreadsheets while another for a different property may use commercial software. In addition, the record keeping function may be carried out by a bookkeeper, rather than the owners.

7.36 A further complication for joint owners of property is the use of either the cash basis (explained below) or the accruals basis where one owner could be on the cash basis and another on the accruals basis. Whilst this is currently the

11 UK Property Notes (publishing.service.gov.uk) See notes for Box 3.

12 Set up a business partnership: Setting up - GOV.UK (www.gov.uk).

case for self-assessment any adjustments needed are carried out on the annual self-assessment return. For MTD it will cause particular problems as the digital records being on two different bases will cause ongoing difficulties.

7.37 Given the significant concern raised by respondents about how this would work and the strong feedback that something was needed to reflect current practice, the OTS recommends that a jointly owned property should be the filing entity for MTD for Income Tax. This view has been widely supported during our consultation. It would make sense for the threshold for MTD for Income Tax for jointly owned property to be set at twice the basic threshold (thus £20,000 in the context of a general £10,000 threshold).

Data from letting agents

7.38 The OTS has been told that the way information is provided by letting agents to landlords is an additional practical complexity. Some letting agents provide the information in the form of a statement in document format or perhaps a PDF. Others provide the facility for an online portal, so that landlords can view or download those details, perhaps into a CSV file or a spreadsheet.

7.39 It would be helpful for HMRC's MTD for Income Tax team to identify third parties who have data relevant to MTD for Income Tax and work with them to improve the way in which they provide data to parties within the scope of MTD for Income Tax.

Non-UK resident landlords

7.40 As explained in Chapter 8 many non-UK resident landlords have difficulties filing information with HMRC online, often because they are unable to pass the verification processes to obtain a Government Gateway ID. This population of taxpayers may therefore not be able to participate in MTD for Income Tax - unless they appoint an agent for the whole process - as they will be unable to access the HMRC systems without a Government Gateway.

7.41 It is possible that many non-UK resident landlords in this situation could apply for exemption from MTD for Income Tax because they are 'digitally excluded'[13] – but guidance on this point would be welcomed.

Reliefs and other provisions using a tax year basis

7.42 Some tax reliefs, for example the furnished holiday lettings regime, work on the basis of criteria which must be met for a complete tax year – so whether or not the criteria is met may not be known until after the end of the tax year.

7.43 The following have been highlighted to us as specific complications where tax reliefs and so on are calculated on a tax year basis. So, although it would not be known until the end of the year in question whether that relief, or way of calculating profits, is available to the taxpayer, yet the taxpayer has to decide each quarter whether that relief will definitely apply.

Furnished holiday lettings

7.44 As explained in Chapter 6, furnished holiday letting treatment depends on whether specific criteria have been met – this is mainly around the number of

[13] Apply for an exemption from Making Tax Digital for Income Tax - GOV.UK (www.gov.uk).

days the property is available for letting and the number of days actually let during a tax year.

7.45 For the purposes of MTD for Income Tax, although there is one reporting obligation for a UK property business (and one reporting obligation for an overseas property business) which covers all properties owned by the taxpayer, the data requirements for any furnished holiday lettings within those business types are slightly different to those of non-furnished holiday lettings properties. For example, mortgage interest is a deductible expense for furnished holiday lettings, whereas for other residential properties relief is calculated as a basic rate tax reduction.[14] The current draft reporting guidance also specifies more transactional detail for non-furnished holiday lettings properties.[15]

7.46 There is therefore currently some uncertainly about what would happen if it became apparent part way though the tax year that quarterly updates, having been completed on one basis, for example as a furnished holiday letting, should have been completed on another basis, such as a non-furnished holiday letting.

Cash basis

7.47 When calculating rental business profits or losses, there are two alternatives for landlords of an unincorporated property business. The default position is that, where total rents for the year are less than £150,000, the accounting records are prepared on the cash basis, which broadly means that subject to some exceptions, the rental profits are calculated based on rents received in the year, less expenses paid.

7.48 The alternative is that the property owner can make an election to use the accruals basis of accounting and calculate profits and losses based on rents due for the year, less expenses incurred. The accruals basis must also be used if total rents exceed £150,000 for the tax year.

7.49 For their MTD for Income Tax quarterly updates the taxpayer must specify whether they are using the cash or accruals basis. However, as access to the cash basis requires rents to be below £150,000 for the whole tax year the landlord may not know until part way through the year, or until the end, which basis should have been used. For example, if rents increased significantly or new properties were acquired, the taxpayer may have to switch from a cash to accruals basis.

7.50 For jointly owned properties (with some exceptions such as spouses), each owner can separately decide which basis to use. As explained under 'Jointly owned property' above, this may well be unworkable for MTD for Income Tax reporting obligations.

[14] See Chapter 3.

[15] Notices made under regulations 3, 8, 12 and 16 of the Income Tax (Digital Requirements) Regulations 2021 (SI 2021) No. 1076) - GOV.UK (www.gov.uk).

Rent a Room

7.51 Rent a Room is explained more fully in Chapter 4 but broadly, where a taxpayer rents out a room in their own home (for example to a lodger) then they can earn up to £7,500 from this tax free.

7.52 If the taxpayer is completing a Self Assessment tax return for another reason, then they simply have to tick a box to say Rent a Room income is less than £7,500. If the taxpayer has no other reason to complete a Self Assessment tax return, they don't need to report their Rent a Room income at all.

7.53 Income which is not required to be declared on the Self Assessment tax return will not be taken into account when applying the £10,000 MTD for Income Tax threshold. This means that, for example, Rent a Room receipts below the £7,500 threshold, will not count towards the £10,000 threshold.

7.54 However, if the individual is mandated into MTD for Income Tax anyway (because they have other income which takes them above the threshold) they will be required to account for all of their property or trading income under MTD for Income Tax, including their Rent a Room income.[16]

7.55 Therefore, under MTD for Income Tax, the taxpayer may have to report their Rent a Room income, even though it will not count toward the £10,000 threshold calculation, and even though there is no pre-existing need to keep detailed records of that income under Self Assessment.

7.56 Further, as the Rent a Room threshold is on the basis of income for a tax year the taxpayer may not know until the end of the year whether they are over or under the threshold, which creates uncertainty in deciding how the income should be reported on a quarterly basis.

General issues

Awareness

7.57 Most respondents to the OTS Survey (52%) were unaware of MTD for Income Tax prior to completing the Survey. Only 17% felt they were aware and prepared for the changes, while the remaining 31% were aware of MTD for Income Tax but felt unprepared for the changes needed.

7.58 The OTS understands that HMRC will roll out a communications and engagement campaign, aimed at taxpayers, to highlight the forthcoming changes and this is to be welcomed. HMRC are also planning more detailed education for agents on the MTD for Income Tax process and again this is to be welcomed as many agents will have a key role in educating their clients. It would be helpful to have a roadmap as part of the campaign showing when these planned rollouts are likely to take place.

Pilot

7.59 There is currently a pilot scheme available for agents and others to test the existing processes but take up is low.[17] Many respondents would like to enter

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16 How does the income exemption work for MTD for ITSA? | The Association of Taxation Technicians (att.org.uk).

17 MTD ITSA pilot numbers plummet as restrictions take hold | AccountingWEB.

some of their clients into the pilot, but are unable to due to the very restrictive criteria, which very few taxpayers will meet. Two common examples are that taxpayers with employment or pension income as well as rental or self-employment cannot join the pilot and those using accounting dates other than 5 April are similarly excluded. There are plans to widen the pilot but to date this has not happened.[18]

7.60 The terms of the pilot – that taxpayers must file a full tax year's quarterly updates, so if they join late in the year they must file all previous quarters' updates – also discourage joiners.

7.61 To fully pilot the scheme, in addition to a complete year of quarterly updates, participants will need to file end of period statements and a final declaration, ten months after the tax year end. So, if a taxpayer is in the pilot for quarterly updates for the year to 5 April 2023, they then have until 31 January 2024 to file their end of period statements and final declaration under the pilot. This leaves just over three months to resolve any issues found in the pilot. The OTS has heard that software developers believe this is an unrealistic timescale to make any changes needed to software.

Correcting filing errors

7.62 HMRC guidance indicates that information in quarterly reports is not cumulative and each of the four quarters are aggregated at the end of the tax year reporting process.

7.63 So, where a quarterly report has been filed and is later found to be incorrect, it must be corrected by re-filing each individual quarterly report where there is an error (for example, a change in basis such as a move from cash basis to accruals basis, perhaps because rents have increased substantially).[19] The OTS has been told that is likely to be a significant extra burden and expense for taxpayers and agents.

Guidance

7.64 Legislation setting out the broad foundations of how MTD for Income tax will work is in place[20][21] and more detailed legislation[22] is being drafted for consultation. Some outline guidance on eligibility criteria has also been published.[23] The OTS has been told that it would be very helpful to have further detailed guidance in place as soon as possible, and also a roadmap for when the guidance will be available. The OTS understands that representative bodies have been requesting this roadmap for a considerable time and have been in consultation with HMRC about the process.

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18 Using Making Tax Digital for Income Tax - GOV.UK (www.gov.uk).

19 Using Making Tax Digital for Income Tax - GOV.UK (www.gov.uk).

20 Finance (No. 2) Act 2017 (legislation.gov.uk).

21 The Income Tax (Digital Requirements) Regulations 2021 (legislation.gov.uk).

22 Notices made under regulations 3, 8, 12 and 16 of the Income Tax (Digital Requirements) Regulations 2021 (SI 2021) No. 1076) - GOV.UK (www.gov.uk).

23 Making Tax Digital for Income Tax for individuals: step by step - GOV.UK (www.gov.uk).

7.65 Until detailed guidance is available it is very difficult for business owners and their agents to plan how their digital records should be kept.

7.66 For example, the current draft guidance gives slightly different record keeping requirements for a general lettings business and a furnished holiday lettings business, with slightly different expenses details being needed for each type.

Conclusion

7.67 The responses to the OTS Call for Evidence and Survey were overwhelmingly negative about the feasibility of a start date of 6 April 2024 for MTD for Income Tax, particularly for property owners, given that the processes have not yet been decided and that, even once decided, software developers will need time and resources to build the software.

Recommendations

The OTS recommends that HMRC should establish a system to deal with MTD for Income Tax for jointly owned properties, for example by making a jointly owned property the MTD filing entity.

HMRC needs to be able to authorise MTD for Income Tax filing agents alongside tax agents. This is needed because letting agents and bookkeepers will maintain digital records and may support quarterly submissions on behalf of some landlords. Specific professional standards and responsibilities will be needed for MTD for Income Tax filing agents.

The OTS recommends that MTD for Income Tax should not apply to landlords until these major points have been dealt with by HMRC and by a range of software providers. Time will be needed to test new systems before adoption.

The OTS recommends that HMRC give consideration to increasing the minimum gross income threshold for MTD for Income Tax for landlords above £10,000, at least for the medium term.

The OTS recommends that HMRC should publish comprehensive detailed guidance on the practicalities of MTD for taxpayers and agents, in good time before the implementation deadline. The current guidance is limited and contains inconsistencies.

Chapter 8

Ownership by non-UK residents

Property income and non-UK residents

8.1 An individual who is non-UK resident is taxable in the UK on income arising from UK residential property (and potentially other UK source income) regardless of whether it is also taxable in their country of residence. Consideration of the relevant Double Taxation Treaties may be needed to resolve any double taxation issues – although typically treaties allocate primary taxing rights to the country where the property is located. This means that those taxpayers who are based outside the UK will need to interact with the UK tax system, including registering for Self Assessment and filing UK tax returns. The UK also operates the Non-Resident Landlord Scheme which applies special rules to non-UK residents with income from UK land and seeks to ensure tax is paid.

Registering and reporting for non-UK resident landlords

Registering with HMRC

8.2 Many non-UK resident landlords must register with HMRC for Self Assessment[1] to report their rental income. The OTS has been told that these landlords often report that they struggle to get access to a Government Gateway account - especially if they don't have a National Insurance number – as they cannot meet the verification requirements.

8.3 Further, when trying to register, activation codes – which are part of the verification process - may expire as there can be delays in being received by post at their overseas location. HMRC states that:

'you will receive an activation code within 21 days of enrolling for a new online service (such as Self Assessment) if you live abroad'.[2]

Activation codes expire 28 days after the date of the letter.

8.4 These issues can cause delays in the taxpayer receiving a Unique Taxpayer Reference (UTR) number, which in turn can cause delays with filing Self Assessment tax returns.

Filing Self Assessment tax returns

8.5 Non-UK residents living abroad are unable to file an online Self Assessment tax return using HMRC provided software. Their choice is either to buy commercial software to file the return online or to file by paper. The OTS has

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1 Register for Self Assessment: Overview - GOV.UK (www.gov.uk).

2 HMRC services: sign in or register: Problems signing in - GOV.UK (www.gov.uk).

heard that most taxpayers in this situation tend to file a paper return, which involves physically posting it from their overseas location, making the process slower and creating a risk of missing or delayed returns. It also causes a great deal of frustration amongst taxpayers, especially those living in countries with a fully online system.

8.6 Individuals also reported that it was unclear in guidance what happens once the paper returns are sent to HMRC, and it would useful if the guidance could make the process clearer.[3]

Claiming a Personal Allowance

8.7 Depending on the non-UK resident taxpayer's circumstances, they may be entitled to a Personal Allowance to offset against their UK taxable income including their UK property income. If non-UK residents are eligible for a Personal Allowance, they can claim this in one of two ways:

- those in Self Assessment can complete boxes 15-17 in the SA109 'Residence, remittance basis etc' pages of the return
- others must submit form R43[4]

8.8 The OTS was told that taxpayers had been going to the extra effort of claiming a Personal Allowance by submitting a form R43 even though they were already in Self Assessment, due to the unclear guidance in this area.

Different tax year

8.9 It was also noted that the UK tax year end being different to that in the foreign country makes it harder for non-UK resident landlords claiming foreign tax credits. This has already been discussed in 'Exploring a change to the UK tax year end date' report.[5]

Recommendations

The OTS recommends that HMRC update the Government Gateway process so it is easier for non-UK residents to obtain the relevant ID and password and manage their affairs online. This could include increasing the length of time the activation code takes to expire for non-UK residents.

The OTS recommends that HMRC review whether the provision of online Self Assessment tax return filing can be expanded so that non-UK residents no longer need to complete a paper form of file using commercial software.

The OTS recommends that HMRC improve guidance around claiming a Personal Allowance as a non-UK resident; the ability to claim this when submitting a Self

3 How to fill in your tax return (publishing.service.gov.uk).

4 Claim personal allowances and tax refunds if you're not resident in the UK - GOV.UK (www.gov.uk).

5 Exploring a change to the UK tax year end date - GOV.UK (www.gov.uk).

Assessment tax return rather than completing a form R43 is not clear in several areas on GOV.UK.

The OTS suggests that HMRC should make it clearer on the paper tax return guidance, when and how taxpayers can expect to hear back from HMRC when they submit a paper tax return.

Non-Resident Landlord Scheme

8.10 The Non-Resident Landlord Scheme (NRLS) was introduced in 1996 to ensure that UK Income Tax is paid on UK rental income arising to non-UK residents.

8.11 A landlord is treated as non-UK resident for the Non-Resident Landlord Scheme where their 'usual place of abode' is outside the UK, which HMRC normally regard as an absence from the UK of six months or more[6]. Where a landlord is non-UK resident, basic rate tax needs to be deducted from their UK rental income and accounted for and paid to HMRC on a quarterly basis. This obligation would normally be done by the letting agent but where there is no letting agent, the requirement instead falls onto the tenant (where the rent is over £100 per week).

8.12 Non-UK resident landlords can apply to HMRC for approval to receive rental income gross (so with no tax deducted) where their UK tax affairs are up to date, or they have never had any UK tax obligations, or they do not expect to be liable to UK tax for the year in which the application is made. HMRC will then give approval to receiving the rental income gross (with no tax deducted) and also register the landlord for Self Assessment.

Operation of the Non-Resident Landlord Scheme

8.13 Forms NRL1, NRL2, and NRL3 are used by individuals, companies, and trustees respectively to apply as a non-UK resident landlord to receive UK rental income gross (with no tax deducted). For non-UK residents able to overcome the challenges of accessing the Government Gateway account these forms can be completed online. Others can fill in a form on GOV.UK, then print it out and post it to HMRC. This initial registration of the landlord was seen as a straightforward process, and commonly supported by letting agents.

8.14 The remaining administration of the scheme involves various actions that the letting agent or tenant (where applicable) need to do:

- registering the letting agent for the scheme (NRL4) – there is an online option provided the letting agent has a Government Gateway. Otherwise, an online form can be completed, printed out and posted to HMRC. A

[6] What the Non-resident Landlords Scheme is - GOV.UK (www.gov.uk).

tenant does not complete a NRL4 and instead needs to write to HMRC to notify them[7]

- provide a quarterly return (NRLQ) and payment – this is needed if there was a requirement to withhold so a payment is due to HMRC. This can only be done via a paper form that either HMRC post out or the letting agent/tenant must request. There is no online option
- provide an annual return (NRLY) and payment – there is an online option provided the letting agent has a Government Gateway. Otherwise, the form can be accessed online and printed out but needs to be completed on paper before being posted to HMRC
- if the letting agent or tenant needs to account for tax, then they need to provide their non-resident landlords with a certificate of tax withheld (NRL6) – this can be completed online and then printed out
- keep records to show that they have complied with the requirements of the scheme

8.15 Although most forms can be completed online if the letting agent has a Government Gateway, the quarterly reporting on NRLQ must be done by paper and although the annual return, NRLY, is available online to print out, it has to be completed in paper format. Reliance on paper and post for administration and communication is a significant drawback and creates a cumbersome and costly process for letting agents/tenants and HMRC.

Recommendation

The OTS recommends introducing online options for the quarterly reporting (form NRLQ) which can currently only be filed as a paper report. The OTS also recommends that the paper option for the year-end reporting (NRLY) can be completed on-screen, for example by providing an editable PDF.

Tenants' withholding tax obligations

8.16 In principle, tenants must withhold tax from their rental payments and pay it to HMRC where the rate of weekly rent is above £100, and the non-UK resident landlord has neither registered for gross payment through the Non-Resident Landlord Scheme nor engaged a letting agent.

8.17 Respondents to the OTS Call for Evidence were clear it was extremely uncommon for residential tenants to do this, and that most were unaware of their obligations. It was also felt that in many cases a tenant may not know that their landlord is non-UK resident if they have a UK correspondence address. It is difficult to see, in practical terms, how the tenant might become aware that these obligations exist: although there is guidance regarding 'Paying tax on rent to landlords abroad'[8] there is nothing in place to raise tenants' awareness to that guidance.

7 Which tenants should operate the Non-resident Landlords Scheme - GOV.UK (www.gov.uk).

8 Paying tax on rent on behalf of landlords who are abroad - GOV.UK (www.gov.uk).

8.18 The OTS also heard that it was felt the rules placed an unreasonable burden of tax collection obligations on these residential tenants particularly as it can put them in an awkward position with their landlord – this would not generally be the case for tenants of commercial properties where there is more likely to be a straightforward business relationship between tenant and landlord.

8.19 HMRC does not hold sufficient data to quantify tenants' compliance levels, but responses indicate most residential tenants are not compliant. Commercial tenants were seen as more commonly compliant, aware of their obligations, and capable of administering their obligations. Improvements are therefore needed.

8.20 Government could consider removing the obligation on residential tenants entirely but would want to consider that this removes the fail-safe withholding mechanism for those who do not use a letting agent, potentially undermining the compliance effectiveness of the Non-Resident Landlord Scheme.

8.21 Alternatively, the threshold (which has not been raised since it was introduced in 1996) could be increased to retain the obligation on higher-value tenancies (including commercial) but remove it from tenants in lower-cost accommodation.

Recommendation

The OTS recommends that the government consider reviewing the policy of tenant withholding given the potential burden and its effectiveness for residential tenants. If tenant withholding is retained, the government could consider raising the threshold, making the withholding obligation on tenants clearer in guidance and finding ways to raise awareness, and clarifying the process to rectify matters if tenants initially do not withhold.

Mismatch of residence criteria

8.22 Differences in definition mean that the 'usual place of abode' test for the Non-Resident Landlord Scheme can give a different result to the Statutory Residence Test, which is a test that allows an individual to work out their residence status each year depending on the numbers of days spent in, and other connections to, the UK.[9] The landlord and letting agent or tenant could have Non-Resident Landlord Scheme administration to complete during the year, even though after the tax year end the individual meets the criteria to be UK resident under the Statutory Residence Test.

8.23 However, the Non-Resident Landlord Scheme requires an 'in-year' test to function, and the Statutory Residence Test can only be performed after the tax year end, hence the 'usual place of abode' test is necessary. Although cases of mismatch were identified by respondents, there was general acceptance of the reason for the differentiation.

[9] RDR3: Statutory Residence Test (SRT) notes - GOV.UK (www.gov.uk).

Annex A

Recommendations in chapter order

Chapter 2 The general tax regime for properties

- HMRC should consider working with relevant third parties on how to improve awareness of UK tax obligations regarding overseas property income and provide better signposting to guidance.
- The OTS recommends that guidance relating to Class 2 National Insurance is updated to reflect the current law.
- The OTS recommends that the government consider adopting a simplified approach that property letting income can in no circumstances make taxpayers eligible for Class 2 National Insurance contributions.
- The OTS recommends that HMRC guidance adopts a consistent interpretation where possible of the word 'business' in relation to property across its instances in the tax statutes – and uses different words in statutes where there are different meanings.
- The OTS proposes that if government are of the view that support be made available to secure UK agricultural production, then HM Treasury and HMRC work with the Department for Environment, Food & Rural Affairs (Defra) to explore the potential for a 'Rural Business Unit' or similar regime for tax, with a view to simplifying the obligations on relevant parties and reducing the complexity of rules applying to diverse rural businesses.

Chapter 3 Ownership and financing

- The OTS recommends that the government should consider removing the anachronistic 50:50 rule for spouses and civil partners and aligning treatment to that of other joint owners and to the position for spouses under Capital Gains Tax and Inheritance Tax. To prevent abuse, the default beneficial ownership position should not be capable of being displaced.
- The government may also wish to consider removing the ability for joint owners to decide on a split other than beneficial ownership.
- The OTS recommends that the government improve the existing guidance in relation to mortgaging and re-mortgaging so that it is clearer and more consistent.
- The OTS recommends that the government consider whether the rules for restricting the level of interest relief when the cash basis is used add unnecessary complexity, and whether the rules should be consistent with those applying when the accruals basis is used.

Chapter 4 Allowances and reliefs

- The OTS recommends that the guidance on the interaction between the property allowance and the finance cost reduction is clarified, including illustrative examples, in particular to cover the complex comparison necessary where brought forward reduction relief interacts with the property allowance, where it can be hard for taxpayers to understand what is the best choice for them.
- The OTS recommends that HMRC ensure the guidance relating to record keeping for the property allowance is consistent with that for Rent a Room relief and enable a means for taxpayers to confirm the amounts received are below the limits, to avoid risk of penalties.
- The OTS recommends that HMRC should clarify whether Rent a Room relief applies if the taxpayer is temporarily away from the home - for example where the whole property is let for a short period during sporting events – and to make this clear in guidance.

Chapter 5 Treatment of certain expenses

- The OTS suggests HMRC improve the guidance showing how the adjustment for private use could be made, by way of case study examples for common situations.
- The OTS suggests HMRC improve the guidance to aid landlords' better understanding of the replacement of domestic items concept with case study examples.
- The OTS recommends that HMRC should enhance the guidance in respect of the boundary between repairs and improvements to include clear examples of common situations, perhaps using flow-charts to lead towards case-by-case answers.
- The OTS recommends that the government consider introducing a broader immediate Income Tax relief for all property costs - other than where work is part of the capital cost of the building, such as the initial fit-out on properties bought in a dilapidated state and structural work such as extensions to the property.

Chapter 6 Furnished holiday lettings

- The OTS recommends that the government consider whether there is continuing benefit to the UK in having a separate tax regime for furnished holiday lettings.
- If the furnished holiday lettings regime is abolished the OTS recommends that the government consider whether certain property letting activities subject to Income Tax should be treated as trading and whether it would be appropriate to introduce a statutory 'brightline' test to define whether a property trading business is being carried on.
- Should the government conclude that the furnished holiday lettings regime be retained, the OTS recommends that the government then consider:

    - removing the current distortion of allowing the regime for properties in the European Economic Area, either by permitting worldwide properties to qualify, or by limiting the regime to UK properties
    - restricting the regime to properties used for commercial letting by removing the potential for personal occupation. This would permit a simpler approach to defining the regime
- The government should consider:
    - providing clear guidance and improving the tax return form to show how non-furnished holiday lettings losses can be set off against furnished holiday lettings profits, with case study examples
    - undertaking a review of each set of guidance on day count rules for furnished holiday lettings to ensure all refer to the different rules for business rates purposes in the various parts of the UK

Chapter 7 Making Tax Digital for Income Tax

- The OTS recommends that HMRC should establish a system to deal with MTD for Income Tax for jointly owned properties, for example by making a jointly owned property the MTD filing entity.
- HMRC needs to be able to authorise MTD for Income Tax filing agents alongside tax agents. This is needed because letting agents and bookkeepers will maintain digital records and may support quarterly submissions on behalf of some landlords. Specific professional standards and responsibilities will be needed for MTD for Income Tax filing agents.
- The OTS recommends that MTD for Income Tax should not apply to landlords until these major points have been dealt with by HMRC and by a range of software providers. Time will be needed to test new systems before adoption.
- The OTS recommends that HMRC give consideration to increasing the minimum gross income threshold for MTD for Income Tax for landlords above £10,000, at least for the medium term.
- The OTS recommends that HMRC should publish comprehensive detailed guidance on the practicalities of MTD for taxpayers and agents, in good time before the implementation deadline. The current guidance is limited and contains inconsistencies.

Chapter 8 Ownership by non-UK residents

- The OTS recommends that HMRC update the Government Gateway process so it is easier for non-UK residents to obtain the relevant ID and password and manage their affairs online. This could include increasing the length of time the activation code takes to expire for non-UK residents.
- The OTS recommends that HMRC review whether the provision of online Self Assessment tax return filing can be expanded so that non-UK residents no longer need to complete a paper form or file using commercial software.

- The OTS recommends that HMRC improve guidance around claiming a Personal Allowance as a non-UK resident; the ability to claim this when submitting a Self Assessment tax return rather than completing a Form R43 is not clear in several areas on GOV.UK.
- The OTS suggests that HMRC should make it clearer on the paper tax return guidance when and how taxpayers can expect to hear back from HMRC when they submit a paper tax return.
- The OTS recommends introducing online options for the quarterly reporting (Form NRLQ) which can currently only be filed as a paper report. The OTS also recommends that the paper option for the year-end reporting (NRLY) can be completed on-screen for example by providing an editable PDF.
- The OTS recommends that the government consider reviewing the policy of tenant withholding given the potential burden and its effectiveness for residential tenants. If tenant withholding is retained, the government could consider raising the threshold, making the withholding obligation on tenants clearer in guidance and finding ways to raise awareness, and clarifying the process to rectify matters if tenants initially do not withhold.

Annex B

Recommendations on where property income guidance can be improved

Chapter	Subject	Current guidance and how it can be improved
2	UK tax obligations regarding overseas property	HMRC should consider working with relevant third parties on how to improve awareness of UK tax obligations regarding overseas property income and provide better signposting to guidance.
2	Definition of business	The OTS recommends that HMRC guidance adopts a consistent interpretation of the word 'business' in relation to property across its instances in the tax statutes – and uses different words in statutes where there are different meanings. There are currently differing interpretations within for example, NIM23800, CG65715 and PIM2010 which could be aligned.
2	Class 2 National Insurance contributions	The OTS recommends that HMRC guidance relating to the liability to Class 2 NIC is updated to reflect current law. NIM23800 Renting out your property: Paying tax and National Insurance - GOV.UK (www.gov.uk).
3	Interest relief on mortgaging and re-mortgaging	The OTS recommends that HMRC improve the existing guidance in relation to mortgaging and re-mortgaging so that it is clear and consistent. Guidance at BIM45700 should be considered and reviewed in the light of this recommendation: BIM45700 - Specific deductions - interest:_Withdrawal of capital from a business - HMRC internal manual - GOV.UK (www.gov.uk). Also the more general guidance at:

		Work out your rental income when you let property -_GOV.UK (www.gov.uk).
4	Property allowance – Interaction between the property allowance and the finance cost reduction	The OTS recommends that the guidance on the interaction between the property allowance and the finance cost reduction is clarified, including illustrative examples, in particular to cover the complex comparison necessary where brought forward reduction relief interacts with the property allowance, where it can be hard for taxpayers to understand what is the best choice for them. This could be added to 'When you cannot use the allowances' within: Tax-free allowances on property and trading income - GOV.UK (www.gov.uk).
4	Property allowance and record keeping. The GOV.UK guidance suggests individuals with income below £1,000 need to keep records, with penalties for failure to do so. This is not consistent with the guidance on Rent a Room which indicates that where receipts are below the £7,500 threshold there is no need to keep anything.	The OTS recommends that HMRC ensure that the guidance relating to record keeping for the property allowance is consistent with that for Rent a Room relief and enable a means for taxpayers to confirm amounts received are below the limits, to avoid risk of penalties. HMRC should ensure the guidance is consistent between: Tax-free allowances on property and trading income - GOV.UK (www.gov.uk) and Letting rooms in your home: a guide for resident landlords - GOV.UK (www.gov.uk). The latter guidance should include specific reference to record keeping requirements to enable a means for taxpayers to confirm the amounts received are below the limits to avoid risk of penalties.
4	Rent a Room relief If the taxpayer is temporarily away from the home for example where the whole property is let for a short period during sporting events.	The OTS recommends that HMRC should clarify whether Rent a Room relief applies if the taxpayer is temporarily away from home – for example where the whole property is let for a short period during sporting events – and to make this clear in guidance. Examples could go within this guidance: Letting rooms in your home: a guide for resident landlords - GOV.UK (www.gov.uk).
5	Private use The wholly/exclusively rule is relaxed to enable a proportion of expenditure to be allowed	The OTS suggests HMRC improve the guidance showing how the adjustment for private use could be made, by way of case study examples for common situations. Guidance could go within this guidance: Work out your rental income when you let property -

	where the expense has part private use. The consultation demonstrated a commonly held view that this is not calculated consistently.	GOV.UK. (www.gov.uk) or within HS253 Furnished holiday lettings (2022) - GOV.UK (www.gov.uk).
5	Replacement of domestic items Taxpayer understanding of the replacement concept.	The OTS suggests that HMRC improve the guidance to aid landlords' better understanding of the replacement of domestic items concept with case study examples. Examples could go on page Work out your rental income when you let property - GOV.UK (www.gov.uk) and also be referred to within PIM3210 - Furnished lettings: Replacement of domestic items relief: 2016-17 onwards - HMRC internal manual - GOV.UK (www.gov.uk).
5	Capital /repair boundary (to include EPC) Taxpayer understanding of the boundary between capital and repair.	The OTS recommends that HMRC should enhance the guidance in respect of the boundary between repairs and improvements to include clear examples of common situations, perhaps using flow-charts to lead towards case-by-case answers. Examples could go on page Work out your rental income when you let property - GOV.UK (www.gov.uk). and also within PIM2030 - Deductions: repairs: is it capital? - HMRC internal manual - GOV.UK (www.gov.uk).
6	Furnished holiday lettings The furnished holiday lettings regime has a day count, as do business rates (which can apply when a furnished holiday lettings property is being used commercially). Many respondents reported confusion or that landlords would misunderstand and use one measure for all purposes.	The government should consider: • providing clear guidance and improving the tax return form to show how non-furnished holiday letting losses can be set off against furnished holiday lettings profits, with case study examples • undertaking a review of each set of guidance on day count rules for furnished holiday lettings to ensure all refer to the different rules for business rates purposes in the various parts of the UK Guidance to be reviewed could include HS253 Furnished holiday lettings (2022) - GOV.UK (www.gov.uk) and HS253 Furnished holiday lettings (2019) - GOV.UK (www.gov.uk).

7	Making Tax Digital	The OTS recommends that HMRC should publish comprehensive detailed guidance on the practicalities of MTD for taxpayers and agents, in good time before the implementation deadline. The current guidance is limited and contains inconsistencies. Using Making Tax Digital for Income Tax - GOV.UK (www.gov.uk). Making Tax Digital for Income Tax for individuals: step by step - GOV.UK (www.gov.uk).
8	Non-resident landlords reporting UK property income – paper returns	The OTS suggests that HMRC should make it clearer on the paper tax return guidance when and how taxpayers can expect to hear back from HMRC when they submit a paper tax return. How to fill in your tax return (publishing.service.gov.uk).
8	Non-resident landlords - guidance around form R43. Depending on an individual's circumstances when they are non-resident, they may be entitled to a Personal Allowance. It is not clear from the guidance whether an individual is entitled to a Personal Allowance to offset against their property income and if so, how they claim it.	The OTS recommends that HMRC improve guidance around claiming a Personal Allowance as a non-UK resident; the ability to claim this when submitting a Self Assessment tax return rather than completing a Form R43 is not clear in several areas on GOV.UK. The Personal Allowance can be claimed on the tax return using boxes 15-17 on SA109 and a Form R43 is not needed. This could be done in the following: Claim personal allowances and tax refunds if you're not resident in the UK - GOV.UK (www.gov.uk). This Form R43 guidance page does not mention that you do not need to complete the form if you need to complete a self-assessment tax return. This could be made explicit. Guidance notes for form R43 (2020) (publishing.service.gov.uk) could be made clearer by making the information about not needing to complete a tax return more prominent as there is currently only a small reference on page 7 under 'C3 Property in the UK'. Tax on your UK income if you live abroad: Personal Allowance - GOV.UK. (www.gov.uk).This should explain that a claim can be made on a tax return instead of Form R43 where the individual is required to file because they have property income.
8	Non-resident landlord scheme – tenant withholding	The OTS recommends that the government consider reviewing the policy of tenant withholding given the potential burden and its effectiveness for residential tenants. If tenant withholding is retained, the government could consider raising the threshold, making the withholding obligation on tenants clearer in guidance and finding ways to

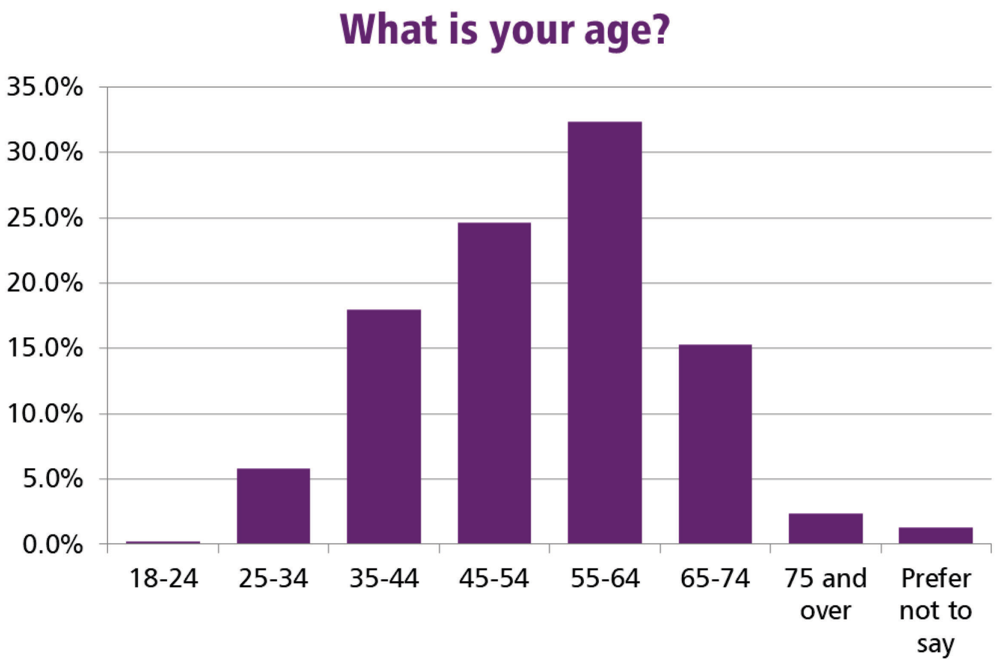
	raise awareness, and clarifying the process to rectify matters if tenants initially do not withhold. Landlord and tenant rights and responsibilities in the_private rented sector - GOV.UK (www.gov.uk).

Annex C
Results of the OTS Survey

3,559 stakeholders contributed evidence to this review through the online survey, which is the highest ever response to an OTS Survey. The OTS is grateful for this evidence, which is summarised below.

Q1. What is your age?

3,519 respondents answered this question, as below.



Source: OTS Property income survey, 2022

Q2. Are you UK resident?

Of the 3,511 respondents that answered this question, 96.8% said they are UK residents, while 1.9% said they are not UK residents. 1.3% preferred not to say.

Q3. Do you receive income from letting out residential property?

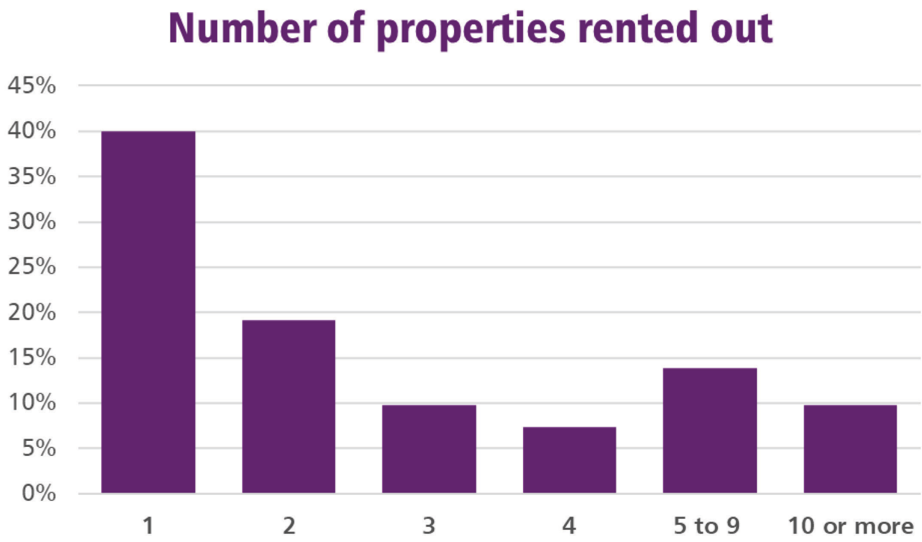
Of the 3,521 respondents that answered this question, 95.4% said they received income from letting out residential property. Some 4.6% of respondents said they did not receive income from letting out residential property and exited the survey.

Q4. Do you let your property/properties on a short term (e.g holiday lettings) or longer term basis?

Of the 3,367 respondents that answered this question, 40.5% said they let property on a short term basis while 38.1% let property on a long term basis. The remaining 21.4% respondents let property on both a long and short term basis.

Q5. How many properties do you let out?

3,361 respondents answered this question, as below.



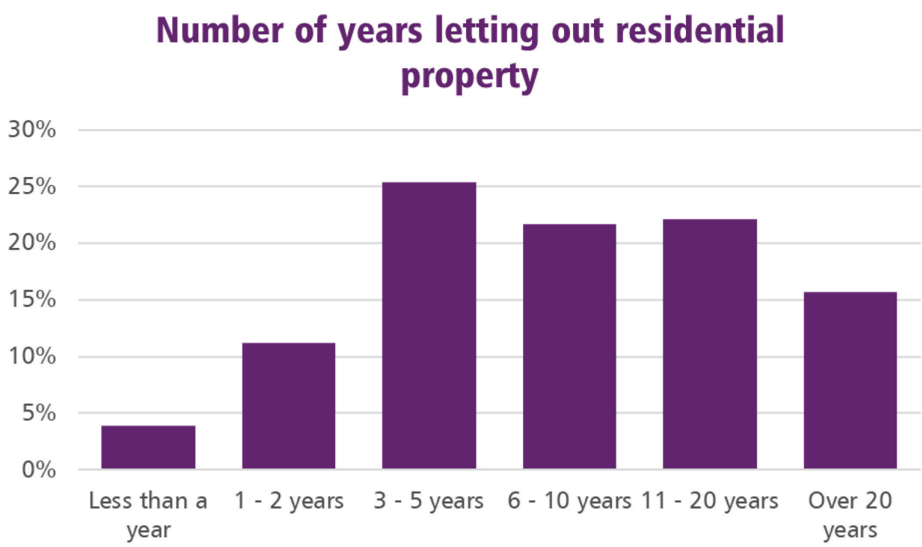
Source: OTS Property income survey, 2022

Q6. Are the property/properties you let situated in the UK or overseas?

Of the 3,361 respondents that answered this question, 97.2% said they only let property in the UK while 0.1% only let property overseas. The remaining 2.7% let property in both the UK and overseas.

Q7. How long have you been letting out residential property?

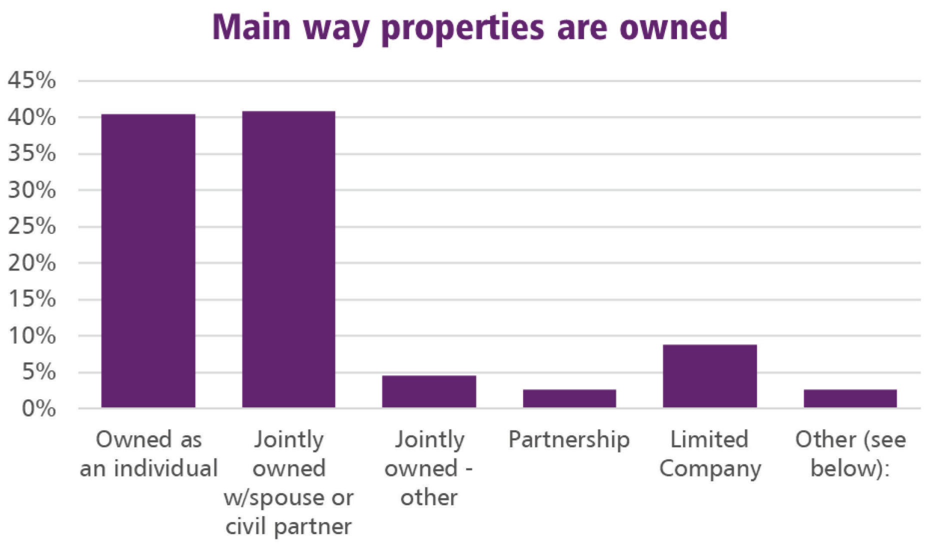
3,361 respondents answered this question, as below.



Source: OTS Property income survey, 2022

Q8. Which of the following describes the main way you own the properties that you let out?

3,362 respondents answered this question, as below.



Source: OTS Property income survey, 2022

Of those that answered 'other,' most explained how they owned several properties, with many owning properties both as an individual and through a company.

Q9. Is the company incorporated in the UK or overseas *[for those who answered 'Limited Company' to Q8]*?

Of the 301 respondents that answered this question, 98% said the company is incorporated in the UK. The remaining 2% said the company was incorporated overseas.

Q10. What was the main factor in deciding to hold the property through a company?

Of 298 respondents that answered this question, some 39.9% said the main factor in deciding to hold the property through a company was professional advice. 27.2% said the mortgage interest restriction for individual owners was the main reason, while 12.8% said the ability share ownership or income more flexibly and 10.7% said limited liability.

Of the remaining 9.4% that answered 'other' around half noted they thought holding property through a company would reduce costs, including their tax liabilities.

Q11. Have you encountered any difficulties understanding the way taxable profits are allocated between you? Please explain.

Of the 1,219 respondents that answered question, 68.9% said no. A further 14.7% said no, but this was because they used an accountant or tax adviser.

Others felt it can be challenging to:

- calculate mortgage interest tax relief
- allocate profits in complex circumstances, for example where two people legally owned half a property each, but then in practice one has a larger beneficial interest or does more work to maintain the property

- apportion expenses, including where an expense could be a repair, an energy efficiency requirement or an enhancement.

Q12: Which of the following describes the main way you acquired the property/properties you let out?

Of the 3,353 respondents that answered question, 27% said they originally purchased their rental property as their main home while 54.8% said they purchased additional property as an investment or pension. Some 4.9% of respondents said they inherited or were gifted additional property, while 0.4% of respondents said their property was transferred from a spouse.

Of the 12.9% of respondents that answered 'other,' many were letting an annex to their main home while others had converted outbuildings or self-built.

Q13. Did you borrow money in order to purchase the property?

Of the 2,749 respondents that answered this question, 77.9% said yes, they did borrow money to purchase the property while the remaining 22.1% said no.

Q14. Have you encountered any difficulties understanding the relief available on mortgage interest paid? Please explain.

Of the 1,619 respondents that answered this question, 34.9% said they encountered difficulties and a further 11.2% used an accountant (so many said they did not need to know the rules themselves). Another 2.9% said they were not aware mortgage interest tax relief was available. 51% said they did not encounter difficulties but 1.9% within the 51% were not aware that any relief was available.

Of those that experienced difficulties, many felt mortgage relief reform had increased complexity and costs for landlords. One said they did not claim the relief due to the complexity. Several respondents:

- felt the changes had been poorly communicated
- suggested HMRC's guidance could be improved
- felt mortgage interest should be considered a business expense

Q15. Are you aware of the £1,000 property allowance?

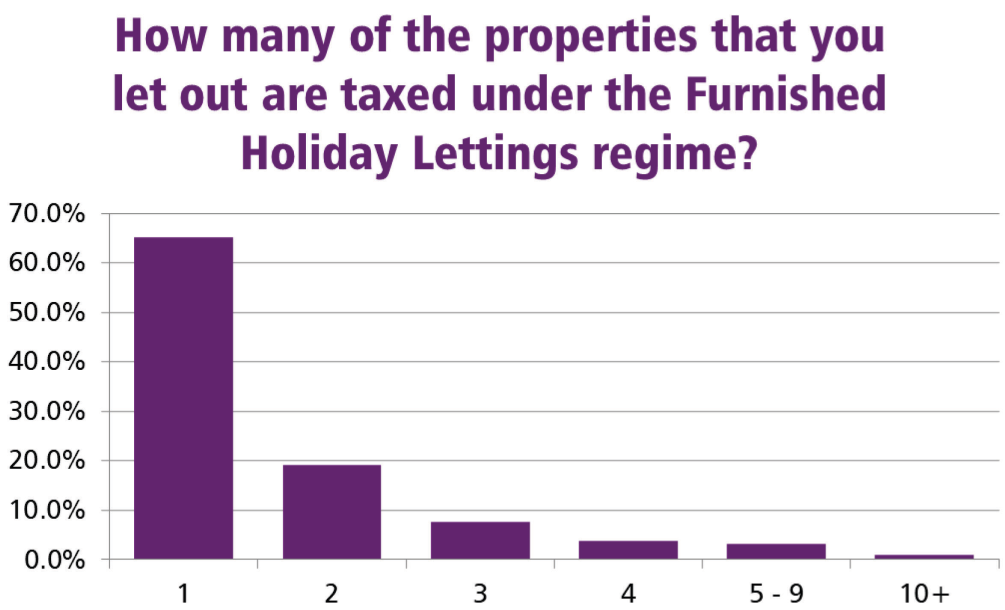
Of the 3,349 respondents that answered this question, 54.6% said they were not aware of the £1,000 property allowance. Of the remainder, 37.5% said they were aware but did not claim it because their expenses were higher, while 7.9% said they were aware and did claim it.

Q16. Are any of the properties that you let out, taxed under the furnished holiday lettings regime (a specific tax treatment for properties let on a short term basis, provided they meet certain conditions, such as the availability of the property and number of days it is let)?

Of the 3,355 respondents that answered this question, 31.1% said yes while 14.9% said they were unsure. The remaining 54% said no.

Q17. How many of the properties that you let out are taxed under the furnished holiday lettings regime?

1,044 respondents answered this question, as below.



Source: OTS Property income survey, 2022

Q18. Do you personally make use of the property/properties?

Of the 1,045 respondents that answered this question, 39.7% said yes while 60.3% said no.

Q19. Are they in the UK or overseas?

Of the 1,047 respondents that answered this question, 96.9% said their property was in the UK while 0.9% said their property was solely overseas. The remaining 2.2% of responses said they had properties in both in the UK and overseas. The location of overseas properties, where provided, is shown below.

Location of overseas properties within the EEA		Location of overseas properties outside the EEA*	
Location	No of properties	Location	No of properties
Croatia	1	Barbados	1
France	6	Switzerland	1
Greece	2	USA	1
Republic of Ireland	2		
Portugal	1		
Spain	6		

*Please note however the furnished holiday let regime only applies to properties in the UK and the EEA.

Q20. How do you manage your lettings (tick all that apply)?

1,044 stakeholders answered this question, and some noted they use several approaches to let their property. 58.5% said they used an international platform to manage their lettings while 31.9% said they used a UK based platform. 17.5% said they used a short term lettings company.

20.9% responded 'other,' and these respondents noted they manage and advertise the properties themselves, even if they advertise with agencies too.

Respondents noted all the answers that apply, so percentages add up to more than 100.

Q21. Are there any particular areas of the furnished holiday lettings regime that cause you difficulty?

Of the 572 respondents that answered this question, 61.0% had no major difficulties.

Of the 39.0% that did have difficulties, some:

- felt the area was complex, and it was difficult to find clear guidance
- highlighted concerns around property tax obligations, including distinguishing between when a property is liable for business rates or council tax or the liability where the owner resides in one part of the UK with a property in a devolved administration
- the 'number of days' rules could be challenging, especially the 105 day rule, especially when tenants cancel at the last minute or demand is seasonal, and the 28 day suggested maximum occupancy rule as some tenants would prefer medium term furnished accommodation (for example, young people starting new careers, contractors)

Others questioned whether it is appropriate that furnished holiday lets are subject to a separate tax regime to other types of property, and whether small business rates relief should apply to single furnished holiday let properties.

Q22. How would you describe the way you let and manage your property? (Please tick all that apply)

2,310 respondents answered this question, as detailed below.

Response	Share of responses*
Obtaining bookings through one or more digital platforms	38.9%
Let and managed through a lettings agent	27.6%
Let through a lettings agent but managed personally	19.7%
Let and managed personally	34.4%
Other (please specify):	1.9%

*Respondents noted all the answers that apply, so percentages add up to more than 100.

Of those who responded 'other,' most said they used a mix of the methods provided.

Q23. Have you ever used the Rent a Room scheme (this lets you earn up to a threshold of £7,500 per year tax-free from letting out furnished accommodation in your home)?

Of the 3,354 respondents that answered this question, 79.3% had not used the Rent a Room scheme while 13.1% currently use the scheme. Of the remainder, 4.9% had used the scheme but no longer qualify and 2.7% had used the scheme but chose to opt out.

Q24. How do you make use of the Rent a Room relief?

437 respondents answered this question, as detailed below.

Response	Share of responses
My income from property is less than £7,500 so the exemption applies automatically	50.6%
My income from property is over £7,500, so I pay tax on the income over this amount	45.8%
Unsure	3.6%

Q25. Where do you go to obtain tax advice? Please tick all that apply.

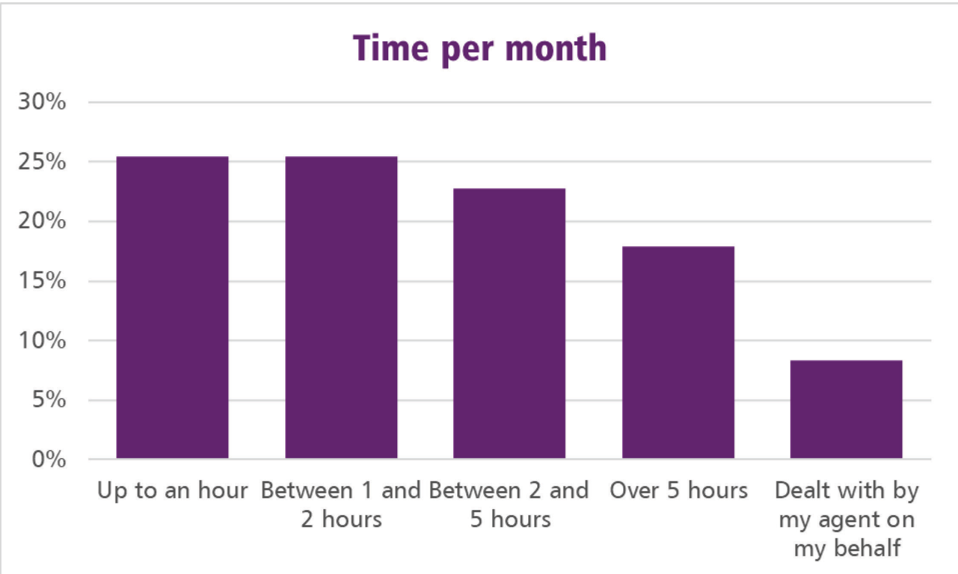
3,351 respondents answered this question, as detailed below.

Response	Share of responses	Response	Share of responses
Accountant/tax adviser	72.0%	Friends/family	11.8%
HMRC (including GOV.UK)	43.4%	Other (please specify):	5.1%
Websites (other than GOV.UK)	27.2%	Letting agent	4.4%
Platforms	13.1%	Tax charity/citizens advice etc	1.6%

Respondents noted all the answers that apply, so percentages add up to more than 100.

Q26. How much time a month do you spend on keeping accounting and tax records for your property business?

3,347 respondents answered this question, as detailed below.



Source: OTS Property income survey, 2022

Q27. How do you keep your accounting and tax records? (Please tick all that apply)

3,342 respondents answered this question, as detailed below.

Response	Share of responses	Response	Share of responses
Spreadsheet	61.7%	General accounting software	18.0%
Paper records	39.8%	Specific accounting software for landlords	4.6%
Electronic records	26.1%	An app on a smartphone	5.4%

Respondents noted all the answers that apply, so percentages add up to more than 100.

Q28. Do you have a specific bank account used just for your property income and expenses?

Of 3,344 responses to this question, 63.7% said yes while the remaining 36.3% said no.

Q29. Making Tax Digital for Income Tax starts in April 2024 and mandates quarterly electronic updates for most individuals with turnover of over £10,000 for their property (and business) income. How aware are you of these reporting obligations?

Of the 3,352 respondents that answered this question, 16.9% said they were aware and prepared while 31.1% said they were aware but unprepared. The remaining 52.0% of respondents said they were unaware.

Q30. Do you pay for an accountant or bookkeeper to help administer your property business tax affairs?

Of the 3,350 respondents that answered this question, 56.8% said they pay for an accountant while 1.6% said they pay for a bookkeeper. 4.8% said they pay for both, while the remaining 36.8% said they pay for neither.

Q31. Do you report your residential property income for tax purposes on the cash basis (that is on the basis of the money you receive and pay, rather than taking debtors and creditors into account)?

Of the 3,352 respondents that answered this question, 65.7% said they use the cash basis while 8.3% said they did not. The remaining 26.0% were unsure.

Q32. Why don't you use the cash basis?

Of the 286 respondents that answered this question, 23.1% said they did not use the cash basis because rents are over £150, 000 per year.

Of the remaining 76.9% that answered other, some said they prefer to use the accruals basis due to their preference, training or software requirements. Some felt it would give more accurate results in their circumstances. Others felt that the cash basis was not suitable for them, in some cases due to apparent misunderstandings of what it involved.

Q33. Do you use your HMRC online Personal/Business Tax Account?

Of the 3,336 respondents that answered this question, 36.8% said yes and they find it helpful while 17.1% said yes but they do not find it helpful. The remaining 46.1% said no.

Q34. On a scale of 1 (Easy) to 10 (Difficult), if you needed to register with HMRC for Self Assessment when you started to receive property income, how easy or difficult did you find this? Leave as zero if question is not applicable.

2,479 responded to this question. 33.7% felt this was reasonably easy (scoring 1, 2, or 3) and 31.0% difficult (scoring 8, 9, or 10).

Q35. On a scale of 1 (Easy) to 10 (Difficult), how easy or difficult do you find understanding and navigating HMRC guidance on the taxation of property income?

2,786 responded to this question. 18.3% felt this was reasonably easy (scoring 1, 2, or 3) and 40.4% difficult (scoring 8, 9, or 10).

Q36. On a scale of 1 (Easy) to 10 (Difficult), how easy or difficult do you find understanding the expenses you are able to deduct from your rental income?

2,767 responded to this question. 23.7% felt this was reasonably easy (scoring 1, 2, or 3) and 36.5% difficult (scoring 8, 9, or 10).

Q37. How do you find the process of filing returns and paying tax? Please tick all that apply.

3,322 responded to this question, as detailed below.

Response	Share of responses	Response	Share of responses
It's dealt with by my accountant	52.0%	Easy to find relevant help/guidance	12.3%
Time consuming	33.5%	High level of predictability about my tax liability	10.4%
Easy to understand my responsibilities	24.8%	Easy to navigate the process	17.9%
Difficult to navigate the process	19.6%	Difficult to understand my responsibilities	14.5%
Difficult to find relevant help/guidance	18.3%	My software deals with it	3.2%
High level of uncertainty over my tax liability	12.3%	Other (please specify):	4.4%

Respondents noted all the answers that apply, so percentages add up to more than 100.

Of the 4% that responded 'other,' around a third stated they used an accountant. Others referred to the difficulties of understanding the forms and accessing relevant guidance.

Q38. Would you find it helpful to be able to make more regular payments throughout the year towards your final tax bill?

Of the 3,340 respondents that answered this question, 61.7% said no while 19.6% said yes. The remaining 18.7% said they don't know.

Q39. Would it be helpful to you if third parties such as platforms, holiday rental agents or letting agents could provide HMRC with data, which you could use to help fulfil your tax obligations?

Of the 3,338 respondents that answered this question, 61.2% said no while 17.3% said yes. The remaining 21.5% said they don't know.

Q40. Please provide any further comments you have on taxation of property income.

1,176 responded to this question, sharing views on a range of issues. These include:

- How third parties, including letting agents and online platforms, could help improve compliance and reduce administrative burdens by sharing data with HMRC. Some agreed this would be helpful, and one proposed third parties could also withhold tax on the landlord's behalf. However, many others felt third party involvement could increase complexity. Several highlighted the risk that third parties may provide HMRC with inaccurate data or a partial picture of their business, especially if they used several third parties or needed to offset expenses.
- The tax treatment of private landlords compared to corporate landlords and those within the furnished holiday lettings regime. Many felt these activities should not be taxed as unearned income. Some underlined concerns around the impact of mortgage interest tax relief reform on complexity and profitability, or the challenges in reaching the 'number of days' thresholds required for the furnished holiday lettings regime.
- The impact of Making Tax Digital and quarterly reporting, including the risk that burdens may be disproportionate for smaller businesses and the impact on the digitally excluded or those requiring digital assistance. This was an area of concern for many respondents.

Annex D
Examples relating to the text

Chapter 3
The effect of interest restrictions
Example 3A

Eliza owns a property which is let on a long term rental.

Eliza's income for each year is:

Type of income	£
Net rents after expenses	20,000
Mortgage interest	11,000
Other income – employment income	35,000

The table below compares the position for 2022-23 if the restriction did not apply (in which case the interest would be fully deductible) and the position with the interest relief restriction.

	2022-23 if full relief given	2022-23 with interest restriction
	£	£
Net rents	20,000	20,000
Interest	(11,000)	
Net income	9,000	20,000
Other income	35,000	35,000
Total income	**44,000**	**55,000**
Income Tax		
@0% on 12,570	0	0
@20% on 31,430/37,700	6,286	7,540
@40% on 4,730		1,892
Interest reduction at basic rate@20%		(2,200)
Total Income Tax	**6,286**	**7,232**

In this example Eliza's tax liability has increased by £946 and the restriction has also had the effect of moving Eliza into the higher rate tax band of 40%.

Example 3B - limitation in the reduction

If Eliza's other income in the example above was savings income rather than employment income, the tax reduction due would be based on the lowest of:

The finance costs for the year plus any brought forward amount -£11,000 (ignoring brought forward amounts)

The profits of the rental business - £20,000

The adjusted total income for year - £55,000-£35,000-£12,270 hence, £7,430

The basic rate reduction for finance costs would therefore be £7,430 at 20%, so £1,486 rather than £2,200 in the example above.

Incorporation

Example 3C

The following example compares the effective rate of tax between individual ownership by basic, higher and additional rate taxpayers, and ownership through a company, using 2022-23 rates.

Rental income	£10,000	
Finance costs	£5,000	
Rate of corporation tax	19%	
Income tax rates	General income	Dividends[1]
Basic rate of income tax	20%	8.75%
Higher rate of income tax	40%	33.75%
Additional rate of income tax	45%	39.35%

[1] Assuming dividend allowance of £2,000 is used elsewhere. Dividend tax rates increased to 8.75%, 33.75% and 39.35% for 2022-23. It was announced on 23 September 2022 that the government plan to reverse this increase from 2023-24, however this was revoked on 17 October 2022

	Individual (basic rate)	Individual (higher rate)	Individual (additional rate)	Company
	£	£	£	£
Property income	10,000	10,000	10,000	10,000
Interest cost	(5,000)	(5,000)	(5,000)	(5,000)
Net income	5,000	5,000	5,000	
Company profit				5,000
Individual taxable income	10,000	10,000	10,000	
Income Tax @ 20/40/45% on taxable income (before interest)	(2,000)	(4,000)	(4,500)	-
Interest reduction at basic rate 20%	1,000	1,000	1,000	-
Net Income Tax	(1,000)	(3,000)	(3,500)	
Corporation Tax on profits (after interest) @19%[2]	-	-	-	(950)
Post tax income/profits	4,000	2,000	1,500	4,050
Effective rate of tax[3]	20%	60%	70%	19%

If income is retained within the company, the lowest effective rate of tax is 19% if a company is used.

However, if post tax company income of £4,050 is paid out as a dividend, the effect is as follows:

[2] The Corporation Tax rate was planned to increase to 25% from 1 April 2023, but it was announced on 23 September 2022 that the government do not intend to make this change. In any event under the original proposals a small profits rate of 19% would apply to trading companies and those letting land commercially, with profits of less than £50,000 (CTA 2010 s 18N). This example assumes that the small profits rate of Corporation Tax applies.

[3] Tax paid on net income of £5,000.

	Individual (basic rate)	Individual (higher rate)	Individual (additional rate)
	£	£	£
Dividend payable	**4,050**	**4,050**	**4,050**
Income tax @ 8.75/33.75/39.35%	(354)	(1,367)	(1,594)
Post tax income	3,696	2,683	2,456
Tax paid by individual	354	1,367	1,594
Tax paid by company	950	950	950
Total tax paid	1,304	2,317	2,544
Effective rate of tax[4]	26.08%	46.34%	50.88%

As can be seen from the above examples, if income is paid out of the company, for a basic rate taxpayer the effective rate is higher at 26.08% compared to 20% if the asset is held personally.

In practice a small amount of pre-tax profits would be paid as salary but this has been ignored for simplicity.

For higher and additional rate taxpayers the effective rates are lower in these circumstances at 46.34% and 50.88% compared to 60% and 70% in personal ownership.

Chapter 6

Furnished holiday lettings

Averaging election

If one or more FHL properties are held which meet the conditions apart from the 105 day count letting condition it is possible to elect to average the tests across qualifying and non-qualifying properties.

Example 6A

Sophie owns two properties in Devon which she lets out as furnished holiday accommodation. During 2020-21 both properties were available for letting for 252 days. One property was let for 84 days and the other for 130 days. Averaging the days let across the two properties gives an average let period of 107 days each, so that both qualify.

[4] Total tax paid by individual and company on net income of £5,000.

If more than two properties are owned not all the properties need to be averaged, so choosing the best combination to average can add complexity.

Example 6B

Grace owns 3 properties in Devon which are let out as furnished holiday lets. During 2020-21 all three properties were available for more than 210 days, and were actually let as follows:

A 130 days

B 8 days

C 77 days

If all three were averaged, the average let period would be 97 days and so none of them would qualify. However, the averaging election can be made for properties A and B only, giving an average of 107 days so that both A and B would qualify, but property C would not qualify.

If FHLs are owned in the UK and in the EEA the averaging process must be done separately for the UK and EEA properties.

An election for averaging must be made by the 31 January in the second year following the tax year concerned, for example by 31 January 2024 for the tax year 2021-22. It is normally made in a tax return.

Period of grace elections

If a property meets all the conditions for a particular year, but in the following year does not meet the letting condition, despite the property being available for the qualifying number of days it is possible to make a period of grace election to continue to treat the property as an FHL. An election can also be made for the following year.

The availability condition and the pattern of availability condition must be met for all years affected. In addition there must be a genuine intention to let the property for 105 days despite this not in fact being achieved, due for example to reduced demand or other unforeseen circumstances. In 2020-21 this included circumstances where the property could not be let due to lockdown restrictions. Some more limited restrictions remained in 2021-22 but it does not seem that any concessions have been granted for that year.

Example 6C

Leo has an FHL property which meets the availability and pattern of letting conditions. The property was advertised and there was a genuine intention to let it, but the days let out were as follows:

2018-19: 120 days

2019-20: 95 days

2020-21: 100 days

2021-22: 110 days

In 2019-20 and 2020-21 the property does not meet the letting condition but Leo can make period of grace elections for both years so that it continues to qualify. In 2021-22 the letting condition is met, so the property qualifies throughout.

If the letting condition was not met in 2021-22 the property could no longer be treated as an FHL from that year. The consequences of this are explained in Chapter 6.

An election must be made by the 31 January in the second year following the tax year concerned, so by 31 January 2024 for the tax year 2021-22. It would normally be made in a tax return.

Annex E

Non-Resident Landlord Scheme forms

Table of Non-Resident Landlord Scheme forms

Form	What for	Who	How	
			Online	Post
NRL1, NRL2, NRL3	Register landlord for scheme.	Individuals, companies, trustees.	Online through Government Gateway provided have a user ID.	Apply by post – complete online form which can then be printed and posted.
NRL4/NRL5	Letting agent use to register NRL5 for branches of letting agents where they want each branch to report separately.	Letting agent.	Online through Government Gateway provided have a user ID.	Apply by post – complete online form which can then be printed and posted.
NRLQ	Quarterly reporting and payment. Only needed if payment due.	Letting agent or tenant.	No online option.	Paper form sent or requested from HMRC.
NRLY	End of year reporting.	Letting agent or tenant.	Online through Government Gateway provided have a user ID.	Apply by post – form available to print out. Then needs to be completed by hand and posted.
NRL6	Certificate of tax withheld.	Letting agent or tenant give to landlord.		Complete online form, print out and give to landlord.

Annex F
Scoping document

Property Income Review Scoping Document

Introduction

The primary focus of the review will be to identify opportunities for simplification of the tax and administrative treatment of individuals, partnerships or micro companies deriving income from residential property.

Background

HMRC statistics suggest that there were around 2.9m individuals and 32,000 partnerships with property businesses filing tax returns in the 2018-19 tax year. These businesses may relate to commercial or residential properties (including Furnished Holiday Lettings) either in the UK or overseas.

Income from residential property owned by individuals is taxed under one of two different regimes.

The general position for individuals with property income is that income tax will be due on the profits from renting out the property at general income tax rates, after certain allowable deductions, including general maintenance and repair and letting, legal or accounting fees. However, residential property mortgage interest relief is restricted to the basic rate of income tax, and there are no specific capital gains reliefs.

The position is different within the Furnished Holiday Lettings (FHLs) regime which applies to residential property let on short term lets within certain parameters.[1] The regime was introduced in 1984 and means, in particular, that the income attracts some reliefs (such as forgoes in Chapter 2 interest) in a similar way to trading income. In addition, some capital gains tax reliefs are available including Business Asset Disposal Relief, holdover relief for gifts and rollover relief for reinvestment into other trading assets.

Separately, the rent a room scheme[2] provides a tax exemption for individuals receiving up to £7,500 a year from renting out furnished accommodation within their home.

Companies are subject to corporation tax on their profits from renting property and have no restrictions on the amount of mortgage interest they can deduct. This review will consider the letting of property by micro companies, but will not examine property development or letting by larger companies or REITS.

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1 The property must be available for commercial letting of short term furnished holiday accommodation for at least 210 days in each tax year and actually let as such for at least 105 days.

2 Rent a room in your home: The Rent a Room Scheme - GOV.UK (www.gov.uk).

Scope of the review

The review will consider the current regimes for the taxation of residential property held by individuals, partnerships and micro-companies, and develop recommendations for simplification and ways of addressing distortions.

The primary focus of the review will be on income received from property.

In particular, the review will consider:

- the way that the taxation of property income fits into the overall scheme of income tax, and the rationale for the similarities and differences between the treatment of property and trading income, and income from other investments, and related rules in other taxes
- the differences between the rules for residential lettings generally and those applying to Furnished Holiday Lettings, the incorporation of property businesses, including SDLT aspects
- the factors that influence the choice between using the cash basis rather than accruals accounting, where rental income is less than £150,000 a year
- reliefs and exemptions, including CGT aspects, and whether the way they operate meets policy intent
- income received from property in the UK, including by individuals living abroad
- income from property overseas, including the complexities of the definition of qualifying EEA property in relation to Furnished Holiday Lettings
- any difficulties arising in understanding the rules, or in the tax processes involved in becoming or ceasing to be a landlord
- the impact of the use of intermediaries by those letting property, and any potential for them to assist in easing administrative burdens

The review will have regard to issues that may arise in relation to:

- the various stages in a property's existence or as a result of changes in its use or ownership
- properties held for the purposes of a property business, or held as an investment, and related regulatory considerations
- rental properties, including buy-to-let properties, holiday accommodation, rent-a-room relief and the £1,000 de minimis allowance
- issues arising in connection with life events or family circumstances
- developments in the ways third party data could be used by HMRC to assist taxpayers
- practical, technical and administrative issues, including in relation to MTD reporting

In carrying out its review, the OTS will:

- be guided by contemporary research

- consider the likely implications of recommendations on the Exchequer, the tax gap and compliance
- take account of relevant international experience
- liaise with HMRC's Administrative Burdens Advisory Board
- consider the implications of devolution of tax powers and different legal systems within the UK
- be consistent with the principles for a good tax system, including fairness and efficiency be mindful of the effect of taxpayer trust in the operation of the tax system

Annex G

Organisations consulted

The OTS has listed below the wide range of organisations who gave their time to provide evidence to this review. The OTS is grateful to these organisations and to the large number of individuals who gave their time to provide evidence either in writing or through the online survey. Individual names have not been published here.

Ashtons Legal

Association of Accounting Technicians

Agricultural Representative Bodies Group

Airbnb

APARI

Association of Scotland's Self Caterers

Association of Taxation Technicians

Azets

Central Association of Agricultural Valuers

Chartered Institute of Taxation

Country Land and Business Association

Deloitte

Department for Business, Energy & Industrial Strategy

Guymer King

Hammock

Hamptons

Historic Houses

HM Revenue & Customs

HM Treasury

Institute of Certified Bookkeepers

Institute of Chartered Accountants in England and Wales

Institute of Chartered Accountants of Scotland

KPMG

London Society of Chartered Accountants' Taxation Committee

Low Incomes Tax Reform Group

National Farmers' Union

National Residential Landlords Association

PayProp United Kingdom

PKF Francis Clark

Propertymark

PwC

Rebecca Benneyworth Ltd

RSM

Saffery Champness

Society of Trust and Estate Practitioners

Tax Policy Advice

The Holiday Home Association

The Professional Association of Self Caterers UK

The Tourism Alliance

UK200 Group

UK Short Term Accommodation Association

untied

Whitings LLP