

## Capital withdrawn from a property letting business

### (Lecture B1057 – 11.18 minutes)

A worrying recent tax development is that HMRC appear to have changed their attitude towards remortgaged rental properties, denying interest relief on additional borrowings where capital is withdrawn from the property letting business.

The position for many years has been that, if an individual client with such a business asks the question 'Can I remortgage my let properties and extract the money for my own use?' The answer to this query has invariably been in the affirmative. Deductions for a property letting business are, broadly speaking, treated in the same way as deductions for any other type of business.

Admittedly, where the let property is residential, the deduction for interest and other finance charges is subject to a 25% restriction in 2017/18, ie. only three-quarters of the relevant costs are allowable, with the remaining quarter being relieved by way of a basic rate tax reducer. This part of the legislation is not relevant to the current problem.

The standard practice has been that the buy-to-let property owner can remortgage his properties and take out capital from the property letting business, subject only to the proviso that his capital account does not become overdrawn. All his mortgage interest (including additional payments relating to the new loan) should be eligible for tax relief.

If the taxpayer extracts no more than the capital that he originally brought into the business (ie. the market value of the properties when they were first let), there should be no effect on the tax position. The fact that a greater proportion of the capital in the business is now supported by a mortgage would appear to be completely irrelevant.

This position is illustrated in Para BIM45700 of the Business Income Manual that includes the example of a Mr A who owns a London flat which he bought some years ago for £125,000. He has a mortgage of £80,000 on this property. He has recently been offered a job abroad and so he intends to move there to live and work. Given that Mr A is likely to be returning to London at a later stage, he decides to retain the flat and rent it out. The London flat has a current market value of £375,000. The opening balance sheet of Mr A's property letting business shows:

Property at market value	375,000
Less: Mortgage	<u>(80,000)</u>
MR A's CAPITAL ACCOUNT BALANCE	<u>295,000</u>

Mr A renegotiates the mortgage on the flat, converting it to a buy-to-let mortgage, and, in doing so, he borrows a further £140,000. He then withdraws the £140,000 that he uses to buy a flat near his new place of work.

The balance sheet at this stage shows:

Property at market value	375,000
Less: Mortgage	<u>(220,000)</u>
MR A's CAPITAL ACCOUNT BALANCE	<u>155,000</u>

The capital account balance is made up as follows:

b/f	295,000
Less: Drawings	(140,000)
c/f	<u>155,000</u>

In HMRC's words:

'Although (Mr A) 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.'

If a client finds himself in the same position as Mr A in the Business Income Manual, one would not be expecting the interest deduction to be challenged by HMRC. However, this is precisely what is now starting to happen. In one reported instance, the HMRC officer who enquired into the client's tax return insisted that the additional mortgage should be used to provide working capital for the property letting business and should not be extracted for private purposes. Unfortunately, this official was not looking at the helpful example of Mr A in Para BIM45700 of the Business Income Manual, but was instead referring to the HMRC guide entitled 'Income Tax When You Let Your Property: Work Out Your Rental Income'. Under the heading 'Increasing your mortgage', this guide says:

'If you increase your mortgage on your buy-to-let property, you may be able to treat interest on the additional loan as a revenue expense, 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.'

The argument appears to have been that, because the interest on the additional element of the mortgage did not relate to something that was used wholly and exclusively for the purposes of the property letting business (ie. under S34 ITTOIA 2005), tax relief for that interest should be denied. But HMRC's contention totally ignores the original 'capital introduced to the business' argument.

It is understood that this dispute is in line for a First-Tier Tribunal hearing.

Bear in mind the words of one well-known tax writer:

'HMRC manuals are not the law. The guidance they contain is guidance which can, and will, be ignored by the Courts if it does not agree with the tax law. However, if you are relying on a section of HMRC guidance to defend a client's tax position, always print a dated copy of the page (given that the words in the guidance) can be changed without notice.'

*Contributed by Robert Jamieson*