

## Proposed Changes to Sideways Set Off of Property Losses

### Introduction

This article is concerned with the proposed changes to the rules for how losses derived from a property rental business can be relieved by income taxpayers. Under the current rules, the part of a loss that is generated from claiming capital allowances can be relieved against the taxpayer's other income in the current tax year, or the following year. This is commonly referred to as "sideways set off." On the other hand, a property loss that is not generated by capital allowances can only be carried forward and relieved against future profits of the property rental business. For simplicity, we are ignoring the treatment of agricultural expenses and also post-cessation property relief.

On 30 June 2011, HM Revenue & Customs (HMRC) issued a consultation document covering sideways set off of losses incurred in a trade, profession or vocation, a property business or in employment. The stated aim of the consultation is "to explore ways of ensuring that genuine business losses and employment losses are relieved, while effectively deferring taxpayers from entering into avoidance arrangements to exploit these loss reliefs."

The consultation document calls for responses by 30 September 2011, which HMRC state will influence any legislative changes that are taken forward. There will be an announcement in the next Budget as to progress and then a further consultation covering the proposed draft legislation during autumn 2012. According to HMRC, any changes to the legislation will not be enacted before 2013. However, in order to stress the need for engagement with this consultation, we look at what the ramifications of the proposals could be for commercial property investors.

### The proposals for property losses

Firstly, it should be noted that the losses derived from a furnished holiday letting (FHL) business were previously restricted to profits of the same business (i.e., carry-forward only) by legislation enacted within the Finance Act 2011. Therefore, there was no need for a FHL business to be included within this consultation. In addition, businesses investing in residential property would not usually be able to claim capital allowances. Therefore, the focus is on commercial property.

The proposals set out in the consultation document to target avoidance are characterised into the following three types of approach:

- Principal-based legislation
- Mechanistic rules
- Administration of the claims

### Principle-based legislation

The appeal of this approach is that it should counter not only existing avoidance schemes, but also the development of future schemes, whilst maintaining relief for genuine losses. However, HMRC acknowledges that the problem with a principle-based approach is being able to distinguish avoidance from genuine losses.

The option put forward in the consultation document for principle based anti-avoidance (option one) is to restrict the sideways loss relief to the amount of the economic loss that the taxpayer has truly suffered. This will entail a consideration of all factors relevant to each situation and obviously could be complicated, subjective and uncertain.

### Mechanistic rules

Such rules would apply automatically whenever certain circumstances are met and would, therefore, have the advantage of providing certainty and should, therefore, be extremely effective in countering avoidance.

The option for a mechanistic rule put forward in the consultation document (option two) is to restrict the sideways loss relief to £25,000 per person in any tax year. This is the same restriction that currently applies to non-active traders and limited partners of partnership trades, but does not currently apply to property businesses. If such a rule was introduced then it would not differentiate between property losses resulting from avoidance schemes and genuine business activity. However, HMRC believes that most claims for sideways set off against general income made by property businesses do not exceed the proposed £25,000 cap.

### Administration of the claims

This approach would entail changing the way that sideways loss relief claims are processed by HMRC and would primarily target avoidance schemes.

The option put forward in the consultation document for this approach (option three) is to withhold relief for claims over £25,000 in the tax year until the claim has been agreed by HMRC. This option would remove the normal self assessment procedure of process first and check later for sideways loss

relief claims over £25,000 in any tax year. No relief would be allowed and no tax repayments would be made until HMRC has formally agreed the claim.

### Examples of how these options would affect genuine property loss claims

We will consider the purchase of an office investment by a limited partnership. The property undergoes a refurbishment in the year of acquisition and the rental income does not cover finance charges for the first tax year. In addition, the capital allowances claimed in the first year, in respect of the plant and machinery forming part of the acquisition and the refurbishment expenditure, increase the partnership loss by £600,000. There are ten equal partners, so sideways loss relief of £60,000 is available against the general income of each partner. Assuming all the partners are high net worth individuals, subject to the highest rate of income tax on general income, the tax saving derived by each partner would be £30,000 in the first tax year.

#### Example — option one

The loss relief would be restricted to the economic loss that the partnership has truly suffered. In the above example, the partnership will have foregone rental income whilst the property was being refurbished and on the basis that the financing was typical of a normal property investment there should be no reason to assume that the principle based option would restrict the sideways loss relief available to the partnership. Therefore, the tax saving for each partner as a result of sideways set off against general income would remain as £30,000 in the first year.

#### Example — option two

The cap of £25,000 would automatically apply to the limited partnership irrespective of the lack of any avoidance motive. Therefore, £35,000 of the £60,000 property loss per partner would be disallowed for sideways set off against general income. Instead, the amount of £35,000 would be carried forward to be relieved against profits of the property business in later years. The restricted relief of £25,000 would save only £12,500 in tax for each partner in the first year, rather than £30,000 previously.

Of course, if the loss carried forward can be utilised against profits of the property business in subsequent years, then the reduction in tax relief in the first year will only amount to a timing difference compared with option one. However, with a possible reduction to the higher rate of income tax coming into being sometime in the future, the partners would obviously prefer to obtain the relief earlier, rather than later. In addition, if the property business ceases before the full loss has been utilised, then the unutilised loss will be forgone permanently.

#### Example — option three

As the loss of £60,000 per partner is over the £25,000 trigger level for this option, the partners would be denied any sideways set off against general income until the self assessment for each partner has been agreed with HMRC.

Therefore, if the loss was incurred in the year ending 5 April 2013, no relief would be available for the tax year until HMRC formally agrees the loss relief claim.

The effective delay to processing the loss relief would necessitate each partner paying additional tax of £30,000 and then reclaiming the tax at the end of the enquiry period. It is uncertain whether the partners would receive interest on the repayment.

### Conclusions

The data provided within the consultation document suggests that the majority of loss relief claims by property investors do not exceed £25,000. However, to then conclude that a £25,000 loss relief cap, as set out at option two, would have minimal effect on the commercial property market, could be completely inaccurate. If we use the data provided for a number of claims made for the tax year 2008/09 and adopt average claim values, the total sideways loss relief claimed for that year was circa £200 million. Of that sum, around £100 million would consist of claims over £25,000 and therefore, on the basis of these assumptions, a cap would have affected a large part of this relief.

The point should also be made that some of the larger loss relief claims could have resulted from syndicated investments on properties qualifying for business premises renovation allowances (BPRAs). The ability to utilise BPRAs against general income is often an essential element of these investments, without which the required regeneration would not take place. As the government has only recently decided in the last Budget to extend the life of BPRAs for another five years, it does not make sense to then remove an essential ingredient for their success.

The problem with option one is the uncertainty that would exist in how HMRC would apply the approach. It is open to speculation as to how HMRC will calculate the economic loss and also how it would view innovative methods of finance. This approach could lead to an increase in cases progressing to litigation and again could well penalise innocent property investors. On the other hand, option three will certainly involve a delay in the taxpayer obtaining the relief and if implemented could be combined with the principle approach set out at option one. Therefore, option three may result in the same outcome as option one, where the taxpayer is forced to litigate to obtain relief for a genuine loss and in addition has to incur the cash flow cost of financing the tax until the case is resolved.

In addition, the question must surely be raised if HMRC will be able to check all the loss relief claims under option three, why is HMRC not able to raise enquiries into such claims now under the normal self assessment regime? If HMRC do not have the resources to check each claim over £25,000 (and the other consultations currently running certainly suggest that to be the case), the result will be the taxpayer's claim is delayed for no reason at all. Also, to treat loss relief claims separately

under the self assessment system adds another element of complexity to the tax legislation, when the focus is supposed to be on tax simplification. We wonder what the Office for Tax Simplification would make of this proposal?

Instead of the proposals contained in the consultation documents, which lumps the losses of property businesses together with those of trades and employment, we recommend that HMRC views property business separately. Rather than adopting blanket anti-avoidance measures, we recommend that HMRC looks at targeted legislation that would prevent accelerated allowances being claimed. This should then remove the need to hit the property market with yet more tax increases but would still effectively target avoidance schemes involving property businesses.

Finally, we must take issue with the timing of this consultation. The economy is still struggling to recover from the financial crisis and much needed investment should be given every incentive to take place. Ultimately, proposals for tax changes that add uncertainty and potential tax increases do nothing but harm to the confidence of investors. We trust this consultation will result in the proposals to limit loss relief being abandoned, so that current incentives to investment are preserved.

For further advice concerning the issues raised, please contact one of our key individuals detailed below or alternatively call our helpline on 0800 526262. Information on other property tax related topics can also be found on our website at <http://bankingtaxfinance.davislangdon.com>.

If you do have any views or observations that you would like us to include as part of our responses to HMRC, please send these to Christine Weaver, before 20 September 2011, by email at [christine.weaver@davislangdon.com](mailto:christine.weaver@davislangdon.com).

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