HMRC - PIM2056 - Restriction For Income Tax Purposes From 2017/18: Apportionment

Apportionment on a just and reasonable basis

A property business may consist of the letting of both a dwelling-house(s) and other lettings. Deductions for interest and finance costs will be restricted only in respect of any loan, or part of a loan, that is for the purpose of the dwelling-house part of the business. It is necessary to consider the purpose of the borrowing – the use made of the funds – during the period when the interest accrues.

Where the business has separate borrowings for the dwelling-house(s) letting and other letting parts of the business - for example where each property owned by the business has a specific mortgage for the acquisition of the property – then the interest on the mortgages for the residential properties will be subject to the restriction. Interest on the mortgages that relate to letting of other properties will not be restricted as long as the borrowings continue to be used for that purpose.

Sue has owned two residential properties for a number of years. Each cost £100,000, financed by mortgages of £80,000 on each property. Sue acquires a further non-residential property costing £150,000 with a mortgage of £130,000. The interest payments on each loan would be considered separately, looking at the purpose of the borrowings (in the year under consideration). Therefore the interest paid on each of the £80,000 mortgages would be restricted as they relate to that part of the property business that generates income from dwelling-house(s). The interest on the later £130,000 mortgage on the commercial property would be deductible from profits in full.

Where a property business consists of letting both a dwelling-house(s) and other letting then it may be necessary to apportion interest and finance costs on any loan which has been taken out for the purposes of the whole letting business.

The legislation does not stipulate how the apportionment is to be made, other than that it must be on a ‘just and reasonable basis’. The examples below are not a list of acceptable methods but rather demonstrate some types of approaches for making an apportionment that may be appropriate

Huzayfa takes out a mortgage of £120,000 towards the purchase of a rental property in Sheffield which has a retail shop on the ground floor, with a separate residential flat on the first floor. The mortgage provider valued the shop premises at £50,000 and the flat at £150,000 (a combined value of £200,000). Huzayfa’s annual mortgage payments include interest of £4,800.

To decide how much of the mortgage interest is subject to the restrictions applying to a ‘dwelling-related loan’, Huzayfa multiplies the interest cost of £4,800 by 0.75 (the proportional value of the residential flat)). This gives a figure of £3,600 interest to which the finance cost restrictions apply. See PIM2058 for how the restriction calculations work.

Huzayfa may deduct the balance of £1,200 from his property rental income, as part of the calculation used, to arrive at his taxable rental profit.

If Huzayfa sells the retail shop 3 years later and uses the £60,000 proceeds to repay some of the borrowings. The remaining borrowings will be for the purpose of the residential flat – this is the only property remaining in the business. Interest on those borrowings will then be restricted.

If Huzayfa retains both parts of the property but has enough (say £50,000) to repay some of the loan, the repayment reduces the total loan to £70,000. The interest on the £70,000 is apportioned in accordance with the relative original costs of the two parts of the building. The repayment could not be deemed to relate to an element of the loan referable to the residential property only.

Andy owns a building which includes both residential and office accommodation. The central heating system throughout the building has been causing problems so Andy takes out a loan of £10,000 to have much of the pipework replaced. His annual loan payments include interest of £800.

To decide how much of the mortgage interest is subject to the restrictions applying to a ‘dwelling-related loan’, Andy compares the floor areas of the commercial and residential parts of the building. The residential parts make up 40% of the whole floor area of the building, so he applies that proportion to the annual interest costs to arrive at a figure of £320 to which the finance cost restrictions apply.

Andy may deduct the balance of £480 from his property rental income, as part of the calculation, to arrive at his taxable rental profit.

Amanda inherits a rental property which consists of several self-contained small office premises. The property is dilapidated and not generating as much income as she would like. She decides to convert some of the office space into a one-bedroom rental flat and upgrade the remaining office premises. She borrows £80,000 to do the work. Of that, she uses £70,000 for the flat conversion, and £10,000 to upgrade the office space. Her annual mortgage payments include interest of £3,000.

To decide how much of the mortgage interest is subject to the restrictions applying to a ‘dwelling-related loan’, Amanda multiplies the interest cost of £3,000 by 0.875 (the amount spent on the flat as a proportion of the whole loan). This gives a figure of £2,625 to which the finance cost restrictions apply. See below for how the restriction calculations work.

Amanda may deduct the balance of £375 from her property rental income, as part of the calculation, to arrive at her taxable rental profit.

Example 5

Plush Properties LLP carries on a large property rental business with a substantial number of both residential and commercial properties. From time to time it takes out loans to acquire new properties or to fund specific work needed on particular properties. It calculates the finance cost restriction for those loans using one of the methods in examples 1 to 3 above.

It also has a revolving overdraft facility with its bank, which it draws on from time to time to fund general working capital costs for the property business as a whole. To decide how much of the overdraft interest is subject to the ‘dwelling-related loan’ restrictions, Plush Properties LLP compares the rents received from the residential properties against those from the commercial properties. 30% of the rent is from residential properties, so Plush Properties LLP applies the ‘dwelling-related loan’ restriction to that proportion of the overdraft interest for the year.

There may be other acceptable methods of apportioning finance costs where those costs have arisen from a loan or credit facility to provide general working capital for the business. For instance, it may be appropriate in some cases to calculate the apportionment based on the amount of staff time devoted to each element of the business. We expect businesses to apply their appropriate methodology consistently unless there were good reason to change.

Businesses may have in place a revolving credit or overdraft facility for a number of years, to provide capital to acquire new properties, make improvements on properties and/or to fund general working capital. The balance outstanding could also reflect the proceeds of property sales and other receipts. It may not be practical or possible to accurately attribute the proportions of the borrowings that relate to the dwelling-house(s) and other parts of the property business at a particular time. It may then be acceptable for the apportionment to be made for a year on the basis of the relative proportions of dwelling-house(s) and other properties in the portfolio at that time.

When making such an apportionment it should be remembered that the purpose of borrowing money is to finance real cash spending and, in this context, the acquisition of real property. So the apportionment should be made on the basis of the original costs (including any improvements) of the properties rather than their current valuation.

Whatever method is adopted to arrive at a just and reasonable apportionment, we expect a business would be able to justify that method by reference to its records. It is not acceptable for businesses to deem, without evidence, portions of their borrowing as relating to a particular property or type of property in order to contrive to minimise the restriction on the interest that may be deducted.

Example 6

A property business has been in existence for many years and has a single account through which all business receipts and borrowings are made. Over the life of the business there have been many property acquisitions, refurbishments and sales but at 6 April 2017 it owns ten properties. These are six residential with a total original cost of £2m and four commercial with a total original cost of £6m. So for 2017/18, 2/8 (25%) of the costs of borrowing would be considered to refer to residential properties (and be restricted in accordance with PIM2056) and 6/8 (75%) would refer to commercial properties and be allowable.

Where a business has a single account/borrowing facility for the whole business with no separate tranches of borrowings for specific purposes, it is not possible to ascertain whether a repayment relates to a specific property. We would not accept a method whereby a repayment or reduction of such a facility is deemed to relate to a particular type of property. Instead the repayment is of the loan facility as a whole and the interest costs must be apportioned on a just and reasonable basis.

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