The Personal Tax Planning Review

THE NEW SCHEDULE A

Robert Argles[1]

Introduction

Little attracts more judicial criticism than the failure of the Revenue to take advantage of the opportunity afforded by the annual Finance Bill to correct perceived anomalies. It suffices to mention the usually hostile comment on the restrictive nature of the deductions allowed in computing emoluments and the reference - now faithfully preserved in the latest 1988 consolidation[2] - to the cost of maintaining a horse. This year's Finance Bill provides some indication that all is not yet lost. The horse is still with us. But the Revenue have turned over several new leaves. One of these is encapsulated in a Schedule recasting the "settlement" provisions found in sections 660 to 685 of the Taxes Act. Other reforms allow for the deduction of post-cessation expenses to meet claims arising after cessation of a trade or profession. The changes to Schedule A set out in the Finance Bill were inspired by a desire to simplify the law and iron out anomalies. As expressed in the Inland Revenue Press Release[3] the purpose is to tidy up the law in preparation for the introduction of the self assessment regime which is to be established by 1996 to 1997 if not before.

Is this avowed purpose achieved? Regrettably the answer must be "No". The various rules governing the computation of Schedule A income which have been with us since 1963 cannot be forgotten on 6th April 1995 when most of the changes take effect. The rules will continue to apply in calculating the profits of companies within the charge to corporation tax.

The Finance Bill effects two changes of fundamental importance in the computation of profits from the exploitation of land. The first (considered at pages 178 to 190 below) is to require such profits to be computed in the same way as the profits of a trade assessable under Case I of Schedule D. The second is to require the

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1 Robert Argles, Tax Counsel, 24 Old Buildings, Lincoln's Inn, London WC2A 3UJ Tel: (0171) 242 2744 Fax: (0171) 831 8095.

2 s.198 of the Income and Corporation Taxes Act 1988 - 'the Taxes Act'.

3 Simon's Tax Intelligence 1994 p 1463 - Budget issue.

computation of the profits and income arising from the exploitation of land outside the United Kingdom to be on the same basis as such profits and income would be computed if the land was in the United Kingdom. Most of the amendments to the Schedule A code are consequential on these changes.

Although the first change is revolutionary in form, it is in part at least no more than the statutory recognition of practices adopted by taxpayers and accepted by the Inland Revenue in the computation of Schedule A income over many years. So for a high proportion of taxpayers receiving rents from land in the United Kingdom the alteration to the method of computing their Schedule A income is likely to make little practical difference. For those who derive an income from land outside the United Kingdom, however, the changes provide both welcome relief and some potentially unwelcome surprises.

Persons affected by the changes

A prominent feature of the new system is that it applies only to income chargeable to income tax. However, the changes are not wholly irrelevant to companies within the charge to corporation tax. Companies resident outside the United Kingdom which are exceptionally assessable to corporation tax in respect of the profits arising from a trade carried on through a United Kingdom "branch or agency" in common with other persons not resident in the United Kingdom (whether companies or not), will have to consider the regulations made under the new regime for assessing non-residents in receipt of Schedule A income made pursuant to the new section 42A of the Act introduced by clause 34 of the Finance Bill. Companies within the charge to corporation tax are also potentially affected by the largely incidental changes to the provisions of the Taxes Act 1988 relating to annual interest on loans to purchase or improve land. These incidental changes are considered at pages 200 to 201 below.

The principal changes to the method of computing Schedule A income will apply to all those receiving or entitled to receive rents or other receipts arising from interests in land which are within the charge to income tax (not corporation tax) including (in the case of persons resident or ordinarily resident in the United Kingdom) land outside the United Kingdom. So changes apply to individuals and settlement trustees wherever resident. They apply also to companies resident outside the United Kingdom which derive a rental or other income from land in the United Kingdom which is not held for the purpose of a United Kingdom branch or agency.

The main changes and their effect

Schedule A remodelled

The Finance Bill clause 33 substitutes a new section 15 of the Taxes Act for the existing sections.

The new section 15 introduces in statutory form an important concept which hitherto found acceptance in practice rather than as a matter of interpretation. This is the "Schedule A business" defined by paragraph 27 of Schedule 6 to the Finance Bill by reference to the expression used in the new para 1(1) of Schedule A as meaning a "business carried on for the exploitation, as a source of rents or other receipts, of any estate, interest or rights over any land ..." From 6th April 1995 income taxable under Schedule A will no longer be computed by reference to the income from individual premises. All the premises from which a person derives Schedule A income will be looked at together. The change renders obsolete the limited relief afforded by section 25(7) of the Taxes Act which provided for setting off the expenses of maintaining one premises against the rents of another, and the now very limited relief afforded by section 26[4] (land managed as one estate in the year of assessment 1962-63). Subject to these provisions the income from rents etc. had strictly to be computed by reference to individual premises.

The expression "Schedule A business" is not limited to continuous activities having the characteristic associated with the word "business". It extends to all one-off transactions (such as the sale of a lease originally granted at an undervalue) giving rise to a charge to income tax as well as to the passive holding of property for rent. Any transaction entered into for the exploitation of a right over United Kingdom land is deemed to be entered into for the purpose of a Schedule A business.

Other substantive changes occasioned by the substitution of the new Schedule A are:

(a) The inclusion in the Schedule of rents or other receipts arising from the conferment of a right to use or occupy caravans and houseboats - provided the use is confined to one location in the United Kingdom,

(b) The inclusion in Schedule A receipts of sums - the taxable proportion of lease premiums, deemed premiums on improvements, premiums on assignments of leases granted at undervalue and the like - previously chargeable under Case VI of Schedule D - see further below.

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4 s.26 itself survives the change.

(c) The inclusion in Schedule A of rents from furnished lettings not taxable as the receipts of a Case I, Schedule D trade.

Other changes in the charging provisions have the appearance of a radical departure but are changes rather of form than substance.

So, for example, the "rents" to which the Schedule now refers are no longer confined to rents from "leases of land". No distinction is now drawn in computing the annual profits or gains of a Schedule A business between rents and other receipts. However, the former distinction between rents and other receipts only assumed significance when applying the provisions which only allow a specific deduction from "rents" as distinct from other "receipts". The abolition of the elaborate rules governing deductions means that the old distinction between rents and other receipts is itself redundant.

The definition of "receipts" which now embraces the old paragraph 1(b) of the Schedule (rent charges, ground annuals, etc) and payments "in respect of any licence to occupy or otherwise use any land or in respect of any other rights over land" is prefaced by the unhappy word "includes". The saving grace here lies in the requirement that the receipts, as presently is the case, must form part of the "**annual** profits or gains" - i.e., they must be of an income nature unless otherwise specified. Thus capital receipts (with the exception of lease premiums and the like caught by sections 34-36 of the Taxes Act) are excluded.

The limitation of "receipts" by reference to the annual profits or gains also preserves the principle applied in *Lowe v Ashmore Limited* [1971] Ch 545 under which payments for the removal of turf were treated as income assessable under Schedule A (since turf is capable of renewal) and the corresponding treatment of a payment for a licence to tip subsoil as capital (*McClure v Petre* [1982] STC 913). Predictably, the new Schedule A preserves the existing exclusion of annual interest derived from loans charged on land, together with the annual profits or gains from activities such as the commercial management of woodlands, farming or royalties from mines or quarries.

The new definition of receipts as including payments in respect of the exercise of a right over land arising from a Schedule A business does not alter the treatment hitherto accorded to service charges and to services provided by a landlord. If the rents are paid in consideration of the provision of services by the landlord as well as for the right of occupation, or if separate payments are made to cover the cost of work of maintenance, insurance or repairs[5] to the premises not being work required by the lease to be carried out by the tenant the rents, the rent or payments will be brought into the Scghedule A computation. But separate charges for services not caught by section 24(6) of the Taxes Act (such as the services of a

[5] See s.24(6)(b) of the Taxes Act 1988.

caretaker and the like) provided by the landlord should be regarded as the receipts of a trade of providing those services assessable under Case I of Schedule D. It can hardly be said that a separate charge levied by the landlord in consideration of an agreement by him to keep the common parts of a block of flats clean and lighted and to provide the services of a caretaker, to maintain the lifts in working order and the like is analogous to a payment in respect of the occupation of land. No doubt the tenant covenants to pay the same and does so as a tenant. But the payment is in respect of the landlord's services - not in respect of the occupation. On the other hand, a payment for services involving repair, insurance or maintenance of the building - even if separate from the rent paid for occupation - might properly be regarded as being paid by the tenant in respect of the occupation of the land. Here, at least, little has changed. But in practice the distinction between a Schedule A business and a trade involving the provision of a caretaker, cleaning and other services will make little difference in view of the more liberal system of deductions for expenses which proceeds on the basis that the income derived from a Schedule A business is to be computed in the same way as trading profits. The distinction only becomes of importance when considering the right of a trader to make provision for his retirement by means of retirement annuity or pension premiums. Case I of Schedule D income counts as relevant income for these purposes. Schedule A income does not.

Furnished Lettings

The concept of the "Schedule A business" and a simpler and more favourable regime allowing deductions in computing the profits of that business has facilitated a change in the treatment accorded to furnished lettings. Until the change, the landlord of furnished premises who was charged to tax under Case VI of Schedule D in respect of the use of furniture, was also to be charged to tax under Case VI in respect of the use of the premises, subject to his right to elect to be charged under Schedule A. Now, unless and to the extent that any sums received by the landlord are treated as trading receipts, the landlord will be chargeable to tax under Schedule A both in respect of sums received for the use of the premises and in respect of sums received for the use of furniture. There is no option to elect for tax under another Schedule.

The concept of the Schedule A business has not affected the treatment of landlords in the position of the taxpayers in *Gittos v Barclay* (1982) 55 TC 633 and *Griffiths v Jackson* (1983) 56 TC 583 involving student lettings. Nor has it altered in other than minor inconsequential fashion the treatment accorded to rents from holiday lettings found in section 503 of the Taxes Act. Unless the landlord can establish himself as an hotelier or bring himself within the holiday letting provisions all his income from land (apart from separate service charges) will be taxed as the income of a Schedule A business. None of that income will qualify as earned income or as "relevant income" to be taken into account in arriving at relief for retirement pension premium relief purposes. Neither the business nor any assets used in it will qualify for "roll-over" or retirement relief (capital gains tax) or as business property for the purposes of inheritance tax.

Experience suggests that it is hard to predict the likely areas of dispute or the opportunities for realistic tax planning following an upheaval in the ways in which income, gains or capital are taxed. But even allowing for a measure of unpredictability it is hard to see how the new Schedule A described above has done other than clarify an untidy area of law.

Computation of income - application of Case I of Schedule D principles for income tax purposes

The person assessed

The basic rules are now to be found in a new section 21 of the Taxes Act. This takes effect (except in cases where a "source" ceases in 1995-96) from 6th April 1995. The new section begins innocuously by providing:

> "(1) Income tax shall be charged on and paid by the persons receiving or entitled to the income in respect of which the tax is directed by the Income Tax Acts to be charged."

At first blush the words "receiving or entitled to" seem inappropriate in relation to net income. But the purpose of section 21(1) is not to provide a measure of the income by reference to which the assessment is raised but to identify the person to be charged. That person will be "entitled" to a net sum - not necessarily the gross rents. Hence life tenants under settlements of land and estates, as well as the beneficial owners of tenanted land are expressly within the charge.

This explains the distinction between this provision and the apparently analogous provision found in the former paragraph 2 of Schedule A which charged tax by reference to the "rents or receipts" which a person becomes "entitled to" in the chargeable period. The effect of the former paragraph 2 was to render the taxpayer liable to tax on rents or other receipts whether they were in fact received or not (subject to the relief provided by section 41 of the Taxes Act). "Income" in the new section 21(1) refers to the net profits or gains of the Schedule A business - not the gross receipts. The answer to the question whether the rents or receipts to which a person has become or may be entitled but has not received are or are not to be included in the profits for a year must now be sought elsewhere.

Entitlement to rent - the arising basis

Under paragraph 2 of Schedule A in the former section 15, the assessment was on profits or gains "arising" but was based on the rents or other receipts which the person concerned received or was entitled to receive in the chargeable period. A change here is necessitated by the requirement to compute the profits or gains as if the Schedule A business was a trade.

From 5th April 1995 Schedule A income will no longer be assessed on the basis of the rents or receipts which a person has received or was entitled to receive. The new section 21(2) provides:

> "(2) Income tax under Schedule A shall be computed on the full amount of the profits or gains arising in the year of assessment."

"Entitlement" to receive rents is no longer vital - although it will usually be decisive in determining whether rent due but uncollected should enter into the computation of Schedule A profits. The test to be applied is the same as that applicable in determining whether a particular debt presently owing or which may become owing should enter into a computation of trading profit.

Given the requirement to compute the Schedule A income by reference to the rules applicable to Case I of Schedule D, those receiving Schedule A income will in future compute that income on the accruals basis applicable to trades rather than the basis of what he has received or is entitled to receive by way of rents.

The chargeable period under the old Schedule A was in every case the current year of assessment. The assessment for the current year[6] was made provisionally by reference to the Schedule A income of the previous year of assessment, provision being made for adjustment when the amounts for the year became known and for cases where the taxpayer was able to satisfy the Inspector that his Schedule A income in the current year was different from the previous year. In practice many taxpayers agreed with their Inspectors an accounting or basis period by reference to which the assessment was to be made which did not correspond to a year of assessment. The change in the law does not recognise that practice. So apportionment of profits or gains arising will be necessary where the taxpayer's "basis period" does not correspond to the year of assessment. Subject to that, the new section 21(2) provides as does the old Schedule A, for a current year basis of assessment. But no provision is made for provisional assessments by reference to the profits or gains of a preceding year.

It is clear from this that the principle under which rents which are receivable although not received will be brought within the computation for Schedule A

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6 See the former s.22 Taxes Act 1988.

purposes is to be preserved. It will still only be possible to ensure that rents receivable are excluded from a computation of Schedule A income by formally waiving the right to payment **before** the date at which the rent is payable. Since the effect of the change to a Case I Schedule D computation will be to allow the person carrying on the Schedule A business to claim bad debt relief, the provisions of section 41 of the Taxes Act which allowed a measure of relief for rent receivable but not received but waived to avoid hardship to the tenant is unnecessary and has been repealed.

Computation

The fundamental changes are in the new subsections (3) and (4) of section 21. These provide:

> "(3) Except insofar as express provision to the contrary is made by the Income Tax Acts, the profits or gains of a Schedule A business and the amount of any loss incurred in such a business shall be computed as if Chapter V of Part IV[7] applied in relation to the business as it applies in relation to a trade the profits or gains of which are chargeable to tax under Case I of Schedule D.
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> (4) All the businesses and transactions carried on or entered into by any particular person or partnership, so far as they are businesses or transactions the profits or gains of which are chargeable to tax under Schedule A shall be treated for the purposes of that Schedule as, or as entered into in the course of carrying on, the one business."

In a high proportion of cases the change will make no difference in practice to the computation of Schedule A income. But for the purpose of the law the changes have potentially far reaching effects. I have already referred to the introduction of the concept of the "Schedule A business". The new subsection (4), consistently with this concept, provides for the computation of the income of the business as a whole and, as indicated above, renders obsolete the provisions of section 25(7) of the Taxes Act. Although the change in the law is itself in part no more than a recognition of practices long accepted by the Revenue, the statutory recognition for such practice is likely to have a far reaching impact in the long-term. The profits of a Schedule A business will now be computed in accordance with sound - or correct - commercial accounting practice. That practice will determine whether a particular sum of rent or other potential receipt arising in the course of a Schedule A business ought properly to be included in a computation of the profits of a year of assessment or not. Of course, commercial accountancy practice only forms the primary basis for such computation. Specific provisions (e.g., those

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7 That is, the rules applicable to the computation of profits for the purposes of Case I of Schedule D.

dealing with lease premiums or prohibiting specific deductions) may well override such practice in striking the balance of profits or gains brought into charge to tax. All deductions as are properly to be made in computing those profits in accordance with the rules of commercial accounting practice as expenses incurred in earning those profits will be allowed unless falling within one or other of the deductions which are expressly prohibited in computing profits for the purposes of Case I of Schedule D.[8]

The change will make evidence of accountancy practice of greater importance in determining whether a particular item of receipt should be included or a particular deduction allowed in a computation of profits. The ability of a taxpayer to make such deduction has hitherto depended on a proper interpretation of statutory provisions upon which both taxpayers or the Revenue have fallen back in the past in cases of dispute. Now they will fall back on evidence of accountancy practice. It suffices to set out what might be described as the three major effects of the change:

(1) For the purposes of working out the expenditure to be deducted from the rents and receipts in striking the balance of profits or gains chargeable to tax under Schedule A it is no longer necessary to bring an item of expenditure within one or more of the "permitted deductions" presently found in section 25(2) of the Taxes Act or (in the case of receipts other than rents) section 28. As a consequence, sections 25, 28 and 31 no longer apply for income tax purposes. All that will be necessary is to apply the basic rule applicable in determining whether expenditure should be deducted in computing the profits of a trade: that is, to ask whether a particular item of expenditure is incurred for the purposes of earning the income derived from the Schedule A business and then to enquire whether the particular class of expenditure falls within one or other of the descriptions of expenditure whose deduction is prohibited mainly by section 74 of the Taxes Act. By way of illustration capital expenditure incurred in the making of improvements or in acquiring the premises will not be allowable.[9] Expenditure on repairs should not be anticipated in computing profits.[10] Expenditure on repair or maintenance of parts of premises which are occupied by the landlord the other parts of which are let will not be allowable.[11] On the other hand, provided it can be shown that the expenditure was deductible in computing the profits of the Schedule A business in accordance with the principles of correct

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8 Certain of the prohibitions are not to be applied - see further below.

9 See s.74 (1)(f) and (g).

10 s.74(1)(d).

11 s.74(1)(a).

commercial accounting, expenditure on works of repair to remedy dilapidations for periods prior to the date at which premises were acquired will be allowable so long, at least, as the purchase price of the premises is not substantially less than if they had been in a fit state of repair and the property capable of letting without the carrying out of the works of repair giving rise to the expenditure.[12]

The dis-application of the present deduction regime found in section 25 of the Taxes Act for the purposes of income tax takes with it subsection (9) which allows all expenditure incurred on common parts (being otherwise a "permitted deduction") notwithstanding that the landlord may enjoy those parts in common with his tenants. It remains to be seen how section 74(1)(a) (disallowing expenditure not incurred wholly and exclusively for the purposes of the Schedule A business) or section 74(1)(b) (disallowing expenditure for domestic or private purposes) are likely to affect such expenditure. The best approach is to assume that if the subjective intent is to provide facilities (in connection with the common parts) which are to be enjoyed by the tenants under the terms of their leases and that the benefit to the landlord or his family is merely the incidental effect of the provision of the facilities, no expenditure incurred in connection therewith will be disallowed. This may prove a minor consideration. But for the effects wrought by the changes considered below, the practical impact of the substitution of the Case I Schedule D deduction rules for Schedule A deductions rules would not be great. Unless repealed, all provisions prohibiting the right of a taxpayer to make a deduction in computing Schedule A income, for example, the anti-avoidance provisions of section 779 of the Taxes Act (limiting the right of a transferor/lessee to a deduction for a head rent not exceeding the commercial rent) will apply as hitherto.

(2) Of greater significance is the abrogation of the basic principle which hitherto required each premises, the rents and receipts from which attracted a charge under Schedule A, to be treated as if it was a separate source of income for the purposes of the Schedule. With two exceptions it was not permissible in law[13] to set off the expenditure incurred in the maintenance or insurance etc in respect of one premises against the receipts or rents derived from another. The main exception was found in section 25(7). But this only permitted the set off against rents payable under leases, other receipts being excluded, and only in cases where the property the subject of the claim was let at a full rent under a lease not

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12 As to this see *Odeon Associated Theatres Limited v Jones* (1971) 48 TC, distinguishing *Law Shipping Co. Limited v IRC* (1924) 12 TC 621.

13 Practice diverged from the law in this respect in many cases.

being a tenant's repairing lease. Deduction was further restricted since it would have to be shown either that the premises in relation to which the surplus expenditure was incurred was let at a full rent or that a "void period" was preceded by a lease at a full rent. The second exception (in section 26) applies only to land comprised in property managed as one estate prior to 5th April 1963. It is now of little practical significance.

Interest

(3) The change in the law affecting the taxation of rents and receipts from land in the United Kingdom which might be characterised as "revolutionary" is that affecting interest. Under the law which subsists until 5th April 1995 interest (not being interest deductible in arriving at profits for the purposes of Case I and II of Schedule D) could only be deducted in computing income for the purposes of income tax if it satisfied the conditions laid down by sections 353 to 368 of the Taxes Act. In respect of land, the rents and receipts of which are assessable under Schedule A, section 354 provided that to qualify as a deduction the interest must be expended on a loan to defray money applied in purchasing an estate, interest or property being land, or a caravan or houseboat, in the United Kingdom or in improving or developing the land or buildings. Interest on loans to provide for the maintenance or repair of property did not qualify unless the loans related to dilapidations preceding the period of ownership. The loans have had also to satisfy the criteria laid down by section 355(1)(b): viz, that the land was during the year of assessment let at a commercial rent for a period exceeding 26 weeks and, when not so let or available for letting, was used as the owner's principal residence. An owner satisfying the primary conditions would then find that he was only entitled to relief to the extent that the interest did not exceed the net income from the land, caravan or houseboat in connection with the purchase (or improvement) of which the loan was incurred.

The changes taking effect from 6th April 1995 sweep away these narrow rules for the purposes of income tax. In future all interest which is "wholly and exclusively" expended for the purposes of a Schedule A business will be deductible in computing the overall profit of the Schedule A business in precisely the same way as interest wholly and exclusively expended for the purposes of a trade. It will no longer be necessary to limit the set off of interest on a loan by reference to the rents arising from the premises purchased with the loan. It will no longer be necessary to consider whether a loan is for the purpose of acquiring or improving premises or, alternatively, for the maintenance or repair of the premises. Letting, or failure to let property at a commercial rent for the requisite period will no longer be directly in point. It is immaterial whether the interest is annual or is short (overdraft) interest. Furthermore, so long as the taxpayer continues to hold property the rents from which are assessable under Schedule A he will be enabled to deduct interest even after the property actually purchased with the assistance of a loan in respect of which the interest is paid has been sold. This reform is likely to have a major impact because in this area Revenue practice has in many cases tended to follow the law.

Under the Finance Bill as originally drafted, those borrowing money to finance a Schedule A business would from 1995 to 1996 onwards have to keep in mind the restrictions found in section 82 of the Taxes Act (interest paid to non-residents). Section 82 was in practice more likely to affect United Kingdom residents purchasing land for investment outside the United Kingdom since they are more likely to borrow overseas to finance such purchases (as to which see below). Unless the United Kingdom resident borrower succeeded in satisfying all the conditions of subsection (2) of section 82, deduction of the interest was only to be permitted in arriving at the profits of the Schedule A business if he deducted and accounted for tax under section 349(2) of the 1988 Act. Hitherto there was no provision in the Taxes Act, in particular in sections 353 to 355, to deny to a United Kingdom borrower the right to deduct interest paid to a non-resident qualifying under sections 353 to 355 in computing his total income.

Now the purpose of the changes in the Schedule A rules is to simplify the law both for taxpayers and the Revenue. Such simplification has amongst its consequences a potentially more generous system of allowing deductions in computing Schedule A income generally and interest in particular. The purpose of the changes is not to impose in respect of income derived from Schedule A business a restriction such as is found in section 82 of the Taxes Act on the right to make deductions in computing the income that did not apply in computing Schedule A income under the old regime. Accordingly it has been announced (see Simon's Tax Intelligence 1995, page 206) that the Finance Bill is to be amended. Section 82 will not apply in computing Schedule A income.

The person from whom the tax on annual interest could be recovered on assessment was generally the lender, whether resident or non-resident (or alternatively the agent or branch having management or control of the interest). Under Extra Statutory Concession B13 the Revenue do not seek to pursue a non-resident for his liability to income tax on Case III annual interest except so far as it can be recovered by set off in a claim to relief (personal relief) in respect of taxed income from other United Kingdom sources. The Concession puts non-resident recipients of such interest at an advantage.[14]

The United Kingdom resident borrower will have to deduct and account for income tax at the basic rate on making the payment of the annual interest in accordance with section 349(2) and the Revenue will have the right of assessment and recovery of such tax under section 350.

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[14] A statutory recognition (and extension) of this concession is now in clause 115 of the Finance Bill.

The restrictions in section 355(1)(b) may seem to be a thing of the past for those whose Schedule A income is assessable to income tax. They remain in force (effectively) in the form of a new section 338A of the Taxes Act for the purposes of corporation tax (see further below).

With the restrictions on relief for interest in arriving at income assessable under Schedule A there is swept away the now redundant restrictions found in section 355(5) (loans to defray expenditure where the person incurring the expenditure is connected with the recipient providing the services). Given the general rule which prohibits any expenditure not incurred wholly and exclusively for the purposes of Schedule A business it is unlikely that these consequential changes will have effect in other than a minority of cases. But the anti-avoidance provisions restricting the deduction of interest in section 787 of the Taxes Act will apply as they apply in the computation of trading profits.

Payment of rent between "connected" persons

One further consequence of equating the computation of Schedule A income with the rules applicable to trading income is that sections 33A and 33B of the Taxes Act have become redundant for the purposes of income tax. These were intended to counter avoidance (intentional or otherwise) of tax where rents or receipts assessable under Schedule A and deductible in computing the profits or gains of the tenant accrued in an earlier chargeable period than that in which they were payable and assessable on the landlord. They were drafted on the assumption that the tenant or other payer would be in a position to deduct the assumed liability when it accrued - rather than when it was payable - and applied when the tenant or other payer was "connected" with the landlord. The perceived mischief was dealt with by providing that the rents or other receipts in such cases be treated as income in the year in which they accrued - not, if different, in the year which they were payable. The provisions remain extant for corporation tax but are now of no relevance for income tax where Schedule A income of the landlord is to be computed on an arising basis (i.e., on the basis of rents accruing) in the same way as the profits or gains of the tenant.

MIRAS

The new computational rules permitting the deduction of interest in computing Schedule A income have necessitated consequential changes to the rules governing the relationship between MIRAS and interest payable in respect of a Schedule A business. These consequential changes take the form of the conferment of a right on the person who is carrying on or proposing to carry on a Schedule A business to take the interest payable by him in respect of the loan to acquire his principal residence outside the MIRAS regime (paragraph 17 of Schedule 6 to the Finance Bill introducing the new section 375A of the Taxes Act). This will apply where the principal private residence is let for a period of time (e.g., on the owner taking up employment elsewhere or acquiring a new principal residence as a second home). The new section 375A applies only where the qualifying borrower intends utilising his home in the course of carrying on a Schedule A business. He will only get a deduction for the interest formerly coming under the MIRAS regime if he has ceased to use the home as a residence.

"Schedule A losses"

The existing Schedule A regime makes only limited allowance for cases where expenditure exceeds the rents or receipts against which it is allowed as a deduction. Where the amount of any "permitted deductions" exceeds the rent payable in respect of particular premises section 25(3) of the Taxes Act allows the excess to be "carried forward" and set against rent in respect of the same premises so long as the excess was of permitted deductions due at an earlier time falling within the currency of the lease and, in the case of works of maintenance and repair, was incurred by reason of dilapidations attributable to a period falling within the currency of the lease. Section 25(7) of the Taxes Act allows a limited relief by set off of surplus expenditure on premises against rents arising from other premises in the same period. Section 355(4) accords relief to the surplus of interest over the rents from premises purchased with the assistance of the loan. The limited nature of relief for "losses" conferred by these provisions is readily apparent.

The Finance Bill has endeavoured to cure what was presumably conceived as a deficiency, but only to a limited extent. It does not, save in two cases, allow relief as against general income of a person incurring a "loss" in computing his Schedule A income. The new section 379A of the Taxes Act (paragraph 18 of Schedule 6 to the Finance Bill) provides:

(1) For a right to carry forward a loss sustained by a person carrying on a Schedule A business either alone or in partnership. The relief is (like that given for trading losses) not dependent on the exercise of a right of election by the taxpayer. The income and the losses are "ring fenced" by only permitting the carry forward and set off of the Schedule A losses against the profits or gains of "that business". That means, in my view, the same "Schedule A business" in respect of which the losses were incurred. If the Schedule A business is discontinued, in the sense that all the land which is exploited for the purposes of commercial letting or otherwise is sold, past losses cannot be carried forward and set against the profits or gains of some future Schedule A business acquired at a later date. The position here is similar to that applying to trading losses but is more generous in one respect in that all Schedule A activities are treated as a single Schedule A "business" the income of which may be relieved by carried forward losses. By contrast, trading losses can only be carried forward to relieve income of the same trade;

(2) For a right to set off against the general income of the taxpayer Schedule A "losses" resulting from (a) claims to capital allowances, or (b) "agricultural expenses" incurred in connection with the management of an agricultural estate. The relief here is dependent on election by the taxpayer and must be made within 12 months of 31st January next following the year of assessment in which the loss was incurred. "Agricultural expenses" are defined in terms similar to those presently found in section 25 of the Taxes Act relating to the old Schedule A. Interest is not for these purposes an agricultural expense. The object here is to preserve the effect of the existing law[15];

(3) The existing (but very limited) rights to carry forward excess interest (section 355(4)) and Case VI losses - where Case VI applied to land transactions - is preserved.

There is thus no general right to set off losses against income other than income from a Schedule A business - and no right to carry back losses whether dependent on election or otherwise. Unless the person carrying on the Schedule A business is the owner of agricultural land or has expended money qualifying for capital allowances he will remain at a disadvantage as compared with the trader assessable under Case I of Schedule D.

In cases where relief for losses is given as against general income of the loss-maker, provisions allowing relief have been conceived in the past as giving rise to opportunities for tax planning. If such opportunity exists here it must be considered as severely limited. It will be essential for those with Schedule A losses to ensure that they have sufficient income from the Schedule A business in future years to exhaust the amount of those losses. On the other hand they will be comforted by the fact that such Schedule A income against which such carried forward losses may be set is to be generated from the Schedule A business as a whole - as distinct from individual premises - and that the Schedule A income is no longer limited to periodic payments such as rent, but also includes balancing charges, lease premiums (the part thereof treated as income under section 34 of the Taxes Act) and the like. It will be vital to ensure that there will be no discontinuance to frustrate any further carry forward for accrued losses. Unlike a trade, however, it will be easier to preserve a Schedule A business. The retention of a single property producing a minimal rent or other receipts will suffice for these purposes.

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[15] But see p 189 relating to capital allowances.

Capital allowances

Under the new "self assessment" regime capital allowances and charges for the purposes of Case I of Schedule D are treated as trading expenses and receipts.[16] In one respect the treatment of capital allowances and charges made in relation to machinery and plant in carrying on what is to be called a Schedule A business has until now mirrored the treatment accorded to capital allowances and charges made in taxing a trade. This is where the machinery or plant is used in the management of the estate (section 32(1) of the Taxes Act 1988). These provisions are left undisturbed, save to the extent that the allowances and charges will no longer be confined to those made in relation to plant and machinery in respect of the management of individual premises but are extended to all plant and machinery used for the purposes of the management of the Schedule A business.

Plant and machinery

In the case of allowances and charges incurred in relation to plant and machinery (other than that used in management) by the person carrying on the "Schedule A business" more extensive adaptations are required. So there is a new section 32(1A) of the Taxes Act to exclude from the allowances and charges taken into account in charging Schedule A income any allowances and charges made in relation to machinery and plant employed in the deemed trade involving the letting of plant and machinery to which section 61 of the Capital Allowances Act 1990 refers.

But in a high proportion of cases the plant and machinery will be affixed to the premises and the rent will be paid both in respect of the right to occupy the premises and the right to use the plant and machinery affixed thereon. In other cases a letting of plant and machinery will be part of the same transaction as the letting of a building. Where such letting (of the plant and machinery) does not itself amount to a trade section 61 of the 1990 Act is potentially applicable. Although the rents and receipts of the leasing activity deemed to be a trade by section 61 of the Capital Allowances Act may not be part of the rents or receipts of the Schedule A business, where the letting of the plant and machinery is in connection with anything done in the "Schedule A business" the allowances or charges given or incurred in the course of the deemed section 61 trade will be made in taxing the Schedule A business as if the business were the trade of the person carrying on the business and were a trade set up and commenced on or after 6th April 1995. The new section 32(1A) does not apply and section 73(2) and (3) of the Capital Allowances Act is dis-applied in such cases.[17] Profits from

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[16] See substituted s.140 Capital Allowances Act 1990 introduced by s.211 Finance Act 1994.

[17] See new s.32(1B) of the Taxes Act - para 8, Schedule 6 to the Finance Bill.

an actual trade of letting plant and machinery have always been treated as the profits or gains of a separate trade and neither the receipts therefrom nor the allowances or charges made in relation thereto will enter into a computation of Schedule A profits.[18]

It should be noted:

(1) The letting of plant and machinery for use in a dwelling-house does not fall within the provisions of section 61 as a "deemed trade". If capital allowances are to be made in respect of plant and machinery for use in a dwelling-house, that letting must constitute an actual trade the profits of which will be assessable under Case I of Schedule D - a point to be kept in mind by landlords of furnished lettings. Alternatively, allowance may be made for the cost of replacement of plant and machinery and wear and tear.

(2) The new section 32(1B) only applies to allowances or charges made in respect of leased plant and machinery by virtue of section 61 of the Capital Allowances Act where the letting of the machinery or plant is "in connection" with anything done in the course of the carrying on of a Schedule A business. If the letting is in the course of a deemed section 61 trade (i.e., not an actual trade) but is not in connection with a Schedule A business, allowances given in respect of expenditure in providing plant and machinery or charges incurred will continue to be given or made by way of discharge or charge to tax and (effectively) is an expense on income of the deemed trade of leasing plant and machinery.[19]

Most lettings of plant and machinery otherwise than in the course of a trade are likely to fall within section 61 of the Capital Allowances Act and will therefore be subject (as from 6th April 1995) to the new subsections (1A) and (1B) of section 32 of the Taxes Act 1988. Where the letting of the plant and machinery is "in connection" with the Schedule A business, the new subsection (1B) dis-applies section 73(3) Capital Allowances Act under which allowances given in respect of plant and machinery let to a lessee who does not use it in the course of a trade or business are available only against rent from that letting. This prevented the lessors of plant and machinery utilising the surplus of allowances over the rents from the letting in such cases against their other income. That limitation does not

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18 The treatment of expenditure in respect of thermal insulation under s.67(2) mirrors the treatment of plant and machinery in this respect, so that the person incurring the expenditure will be deemed to do so in the course of a Schedule A business.

19 This is the combination of the effect of s.73 of the Capital Allowances Act and the new s.140 as introduced by s.211 of the Finance Act 1994 and is now applied by paragraph 32 of Schedule 6 to the Finance Bill.

apply where the letting is in connection with a Schedule A business. But the possibilities opened up by subsection (1B) are short-lived. The new section 379A(2) of the Taxes Act (Schedule A losses) has the same effect as section 73(3). It restricts losses resulting from allowances which may be set against the general income of the person carrying on the Schedule A business to capital allowances in respect of expenditure on the provision of machinery or plant which is let to a person who uses it for the purposes of a trade, profession or vocation. "Losses" resulting from allowances given in respect of expenditure on plant and machinery let to a tenant (e.g., a charity) who does not use it for the purposes of a trade can be set only against Schedule A profits. So the change does not open the door to avoidance closed by section 73(3) of the Capital Allowances Act.

On the other hand, the revised treatment of allowances and charges given or made in respect of plant or machinery let in connection with a Schedule A business appears to circumvent the restriction found in section 141(6) of the Capital Allowances Act 1990 which prevents a set off of the surplus of allowances over income against which they are primarily set against general income. The new section 379A(2) and (3) of the Taxes Act permits a set off of a loss generated by capital allowances under the 1990 Act in all cases to which the new section 32(1B) applies other than those mentioned above.

Industrial buildings etc

Other allowances and charges in respect of industrial buildings and hotels are consequential on the 1994 amendments to the manner of giving allowances and charges and the new concept of requiring the profits of the Schedule A business to be computed as if they were trading profits, i.e., by treating the allowances as deductible expenses and the charges as receipts in computing the profits. Thus paragraph 28 of Schedule 6 to the Finance Bill amends section 9 of the Capital Allowances Act so as to cause a Schedule A business to be treated as if it were a trade for the purposes of industrial buildings allowances and similar provisions apply in the case of agricultural buildings (paragraph 34).

Those now minded to realise the capital value of an industrial building on which they have incurred expenditure qualifying for allowances without incurring a balancing charge by the expedient of granting a long lease out of the interest in the industrial building will have to keep in mind the provisions of section 120 of the Finance Act 1994 modifying the Capital Allowances Act in such cases.

The more generous rules requiring all Schedule A businesses to be aggregated may well provide an incentive to investors with substantial income from other sources to incur expenditure in the construction of industrial buildings or in the acquisition of plant and machinery for letting in connection with Schedule A business. Providing the letting is to a person who intends to use the industrial buildings, hotels or plant and machinery in the course of a trade to be carried on by him, the surplus of the allowances given in respect of such expenditure over the aggregate of the net rents and receipts of the Schedule A business and any balancing charges will be allowed against general income.

Cessations and Partnerships

Cessations

The provisions of sections 103, 106, 108, 109A and 110 of the Taxes Act (which relate primarily to post-cessation receipts) will apply to a Schedule A business as they apply to a trade. Given that a Schedule A business will continue so long as the persons carrying it on own any interest in United Kingdom land which produces an annual rent or receipt and, by contrast to a trade, can be "carried on" merely by the passive receipt of rents and receipts, it will be far easier to establish that a "Schedule A business" has ceased (or not) than it will be to establish whether or not a trade has ceased.

Partnerships

The provisions of section 111[20] of the Taxes Act in the form in which it now appears (providing for the assessment of partners carrying on a trade) are applied to a Schedule A business carried on by partners. The new section 113 - under which there will in future be no discontinuance on a charge of partners so long as one or more of those carrying on the trade before the change continue to be engaged after the change - will apply to partners carrying on a Schedule A business as they apply to a trade. Section 111 will require the profits of a Schedule A business to be computed as if the partnership were an individual but income tax is to charged and loss relief claimed as if the share of the individual partner's profit or loss was derived from a Schedule A business carried on by that person alone. The new rules now applying on the commencement and cessation of a Schedule A business will apply on partnership changes as if the person joining the partnership had himself commenced a Schedule A business and as if the partner retiring had ceased to carry on a Schedule A business.

There are no doubt cases where a Schedule A business is carried on by partners - typically where, for example, a professional firm of partners lets surplus office accommodation. But in a high proportion of cases a Schedule A business carried on by joint owners will be carried on, not by partners, but by trustees - whether the trustees of a settlement or not. How do sections 111 to 113 apply to such trustees carrying on a "Schedule A business"? Trustees carrying on a business involving the management and letting of land and buildings under a settlement or under a trust for sale in which the only beneficially interested persons are tenants in common absolutely entitled can hardly be said to carry on that business as

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20 As now substituted by clause 104 Finance Bill.

between themselves as "partners". The provisions of section 111 (which only apply if a trade is carried on by persons in partnership) would not therefore apply in the typical case of trustees holding land. The provisions of section 113 (which ostensibly apply in any case where there is a change in the persons carrying on the Schedule A business whether partners or not) might, at first blush, appear to have some relevance. However, a change in the identity of the trustees carrying on the Schedule A business - even a change involving the death or retirement of all the trustees and their replacement by new trustees - is not a change in the persons carrying on the Schedule A business to which section 113 applies, save in those cases where the trustees are also the beneficial owners of the underlying properties (i.e., as tenants in common interested in the proceeds of sale).

These provisions apply with effect from 6th April 1995.

Lease Premiums

Until now premiums payable under the terms of a lease only attracted liability to tax under Schedule A pursuant to section 34 of the Taxes Act if paid to the landlord. Sums otherwise falling within the charge on lease premiums imposed by section 34 paid to persons other than the landlord together with all deemed premiums brought within the charge to income tax by section 35 (assignment of lease granted at an undervalue), section 36 (sale of land with a right of reconveyance) were assessable under Case VI of Schedule D. Now all sums taxable under these sections are brought in as receipts of a Schedule A business carried on by the person entitled to the sums. The definition of a Schedule A business is not confined to the business of letting for rent or some other annual receipt. It embraces one-off transactions giving rise to receipts or deemed receipts caught by sections 34 to 36 of Taxes Act.

Little else has changed. In particular, the provisions of section 37 (deductions from premiums) and the adjustments required to capital gains tax computations on the grant of leases at a premium remain unaltered, save to the extent of the changes consequential on the introduction of the new regime. However, the changes to the basic rules for computing Schedule A income which require the financial results of all dispositions forming part of the Schedule A business to be aggregated will have a significant effect in computing Schedule A income attributable to lease premiums since they allow a far more liberal level of deductions (in particular, interest and like payments) in arriving at Schedule A income derived from lease premiums and kindred payments than hitherto. These deductions will be made after the section 37 deductions.

Nothing has been done to disturb the existing rule under which lease premiums received by the trustees of a settlement form part of the capital of the trust fund. So, while such trustees as the recipients carrying on the Schedule A business will be liable to income tax on the Schedule A income derived from the premiums, the deemed "income" is not income which "is to be accumulated" (per section 686 of the Taxes Act). In the case of interest in possession settlements, lease premiums received by trustees will continue to attract income tax at the basic rate only.

Holiday Lettings

The new regime does not affect the treatment of rents and receipts from the commercial letting of furnished holiday accommodation. Such commercial letting will continue to be treated as a Case I Schedule D trade (section 503 of the Taxes Act) for a wide number of purposes: in particular loss relief, relief for pension contributions as earned income. Under the new section 379A Schedule A losses (other than losses attributable to capital allowances and in respect of agricultural estates) cannot be used to relieve income other than Schedule A income. Schedule A income is neither earned income nor within the definition of "relevant earnings" for the purposes of pension contributions relief. So the owners of property suitable for letting as holiday accommodation will be advised to bring themselves within section 503 if possible rather than under the new Schedule A.

OVERSEAS PROPERTY

Until 6th April 1995 rents and receipts from land outside the United Kingdom are to be treated very differently from rents and receipts arising from land in the United Kingdom. Although in practice it may not be difficult to identify a receipt from overseas property as income or capital, the test to be applied in determining whether a receipt is income or capital is that of the law of the country where the land is situate. The major differences between the tax treatment accorded to rents and receipts from land in the United Kingdom and land which is not in the United Kingdom until 6th April 1995 are as follows: first, there is nothing to apply the charging provisions applicable to lease premiums, assignments of leases granted at an undervalue and conveyances with right to reconveyance to like receipts arising in respect of land outside the United Kingdom. Capital receipts from overseas land, such as lease premiums, are taxable if at all as chargeable gains accruing on disposals or part disposals of the land concerned. Secondly, there is no adequate provision allowing for the deduction of expenses incurred in earning the annual profits consisting of rents or other receipts derived from the letting and exploitation of land outside the United Kingdom. This deficiency was highlighted in relation to interest on loans raised to defray money expended in the purchase of land overseas in *Ockenden v Mackley* (1982) 56 TC 2, in which it was decided that interest was not deductible. In that case (see page 6H) the Revenue are reported as accepting - if only as a matter of practice - that expenses such as rates, insurance premiums, agent's fees or commissions, and presumably head rent and the cost of repairs, could be deducted in computing the rental income on the grounds that they were incurred in procuring and maintaining the rents.

Now all this is to change. The change is brought about by two provisions introduced by clause 35 of the Finance Bill. First, there is to be a new subsection

(2A) of section 65 of the Taxes Act 1988. This provides that, subject to the new section 65A[21], income tax chargeable under Case V of Schedule D on "income" which arises from any business carried on or for the exploitation as a source of rents or other receipts of land outside the United Kingdom (which is not income derived from a trade, profession or vocation) "shall be computed in accordance with the rules which are applicable under the Income Tax Acts to the computation of the profits or gains of a Schedule A business". Subject to the new section 65A, all the provisions which apply to permit or deny deductions for the purposes of computing the profits of a Schedule A business carried on in the United Kingdom will apply in computing the profits of the business for the purposes of Case V of Schedule D. The deduction of head rents, rates, the cost of repairs and the like is no longer a matter of Revenue concession or practice. This operates as a statutory reversal of *Ockenden v Mackley*. Interest will be deductible in precisely the same way as if the land was in the United Kingdom.

Secondly, there is to be a new subsection (2B) of section 65 which provides:

> "The provisions of Schedule A will apply for determining for the purposes of subsection (2A) above whether income falls within paragraph (a) of that subsection as they would apply if
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> (a) the land in question were in the United Kingdom, or
>
> (b) a caravan or houseboat which is to be used at a location outside the United Kingdom were to be used at a location in the United Kingdom
>
> and any provision of the Income Tax Acts in pursuance of which there is deemed in certain cases to be a Schedule A business in relation to any land in the United Kingdom shall have effect where the corresponding circumstances arise with respect to land outside the United Kingdom, as if, for the purposes of that subsection, there were deemed to be a business such as is mentioned in that paragraph."[22]

All the provisions and definitions which apply in determining whether a particular transaction or activity amounts to a Schedule A business apply to a like transaction or activity in relation to overseas land. So lease premiums and analogous receipts (e.g, premiums paid on assignments of lease granted for undervalue) will be caught and the income element (if any) will be computed and treated as receipts of a deemed overseas Schedule A business in precisely the same way as if the land was in the United Kingdom. This may carry with it concomitant disadvantages. Until

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21 See below.

22 Clause 35 of the Finance Bill.

now lease premiums and the like paid in respect of land outside the United Kingdom attracted a liability (if any) to capital gains tax.[23] For capital gains tax purposes the taxpayer, in computing the gain accruing on the part disposal taking place when a lease of land overseas is granted at a premium, is entitled to deduct from the premium an apportioned part of the base cost and to index the resulting gain. It is difficult to see how the computational rules prescribed by section 34 of the Taxes Act are likely to produce a more favourable result. Those wishing to grant leases of overseas land at a premium would be well advised to do so before the new regime comes into effect.

Against this there may be minor if inconsequential benefits. Chargeable gains accruing to non-resident "qualifying" settlements in which the children of the United Kingdom resident and domiciled settlor are beneficiaries are treated as the settlor's chargeable gains under section 86 of the Taxation of Chargeable Gains Act 1992. The trust income of such a settlement will not, however, be treated as the settlor's income so long as he and his spouse are excluded from benefit and no income is applied for the benefit of his infant children.

The changes introduced by the new section 65A are intended primarily to adapt the new Schedule A regime to overseas property. They have the following effect:

(1) The "actual Schedule A business" (that is, the United Kingdom business) is to be treated as a wholly separate business from the business involving overseas letting. This has the effect of forestalling any attempt to set off the losses and expenses of one business against the rents and receipts of the other. The treatment of all overseas property transactions as one "business" does, however, have potentially anomalous results as set out below.

(2) Whilst it would appear that the taxpayer is to be entitled to deduct as an expense of his Schedule A business certain of the costs of overseas travel as are mentioned in sections 80 and 81 of the Taxes Act (expenses of foreign trades, travel between trades) the same deduction is denied in computing the profits of the overseas deemed "Schedule A business". One would have thought it more sensible to refuse a deduction for all the expenses to which sections 80 and 81 refer whether for the purposes of a United Kingdom Schedule A business or the overseas Schedule A business.

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23 Deemed lease premiums arising by virtue of the imposition on a lessee of an obligation to do work on the demised premises were unlikely to be taxed under the capital gains tax regime, save insofar as there was a disposal (the grant of a lease) for a consideration which could not be valued, resulting in the substitution of market value for any lease premium or other consideration given.

(3) Overseas furnished holiday accommodation will be taxable under the deemed Schedule A regime applicable to overseas properties and will not be entitled to the privileged treatment accorded to furnished holiday accommodation by section 503 of the Taxes Act (in particular) where it is in the United Kingdom. Those owning holiday accommodation overseas should be advised to conduct any business involving the same (insofar as they can) as a trade.

In common with the new United Kingdom "Schedule A business" regime the provisions will not apply for the purposes of corporation tax. Accordingly, those holding estates or interests in overseas land who wish to avoid the granting of leases of overseas land in circumstances which might overwise attract a charge under sections 34, 35 or 36 of the Taxes Act might be advised first to transfer or convey the land to a United Kingdom company prior to the grant of a lease or other event which might otherwise give rise to a potential charge under these provisions - accepting that the event will give rise to a capital gains tax disposal on the transfer to the company. *Ockenden v Mackley* is of less concern to companies subject to the corporation tax regime because of their ability, on satisfying the conditions found in section 338 of the Taxes Act, to deduct interest as a charge on income in computing their profits.

There is both logic and common sense in treating all Schedule A businesses carried on by a taxpayer in the United Kingdom as one "Schedule A business" for the purposes of the computation of income and assessment. The statutory acknowledgement of the practice hitherto adopted is a welcome contribution to simplicity which is absent from the Schedule A rules applying hitherto. There is also some logic in providing (as does the new section 65A of the Taxes Act) that the income of the deemed "Schedule A business" carried on overseas assessable under Case V is to be computed and assessed as if it was a business separate and distinct from the "actual" Schedule A business carried on by the same taxpayer in the United Kingdom.

Unfortunately, common sense appears to have deserted the draftsman in applying to deemed "Schedule A businesses" carried on outside the United Kingdom the general rule under which all businesses involved in the exploitation of land in the United Kingdom are to be treated as one "Schedule A business" for the purposes of the computation of profits and assessment of the consequent income. There is no problem where all the land overseas is situate in one country. It is then possible to look at the deemed Schedule A business as a single source both for the purposes of computing the profits therefrom and applying any relevant double tax relief. But what if the land owned by the taxpayer is situate in more than one country overseas? How then is the new regime to operate when different rates of tax are applied in each country to the rents and other income received in each of the countries concerned and, potentially, at least, different rules apply in determining the double tax reliefs accorded in respect of income from the different countries in which each parcel of land is situate? Consideration of this topic is outside the scope of a general review. Nonetheless the problem will have to be addressed if confusion is not to attend the introduction of what is otherwise a welcome reform. Time is on the side of the Revenue and taxpayers concerned with the smooth introduction of the new regime. Clause 35(6) of the Finance Bill provides that for the years of assessment 1995-96 and 1996-97 the income derived from rents or other receipts from the exploitation of land outside the United Kingdom shall be computed as if each property from which the rents and receipts were derived was a separate business and as if it was the only (deemed) Schedule A business carried on by the taxpayer. This does not, of course, affect the computation of the profits arising from each such property but it does afford a breathing space in which the problem described in this paragraph can be addressed.[24]

The application of the "actual Schedule A" regime to the deemed Schedule A business carried on overseas involves an extension of the new loss relief found in section 379A of the Taxes Act to losses on deemed Schedule A businesses carried on overseas (clause 35(8) of the Finance Bill). But this will not be until 1998-99. Until then there will be no carry forward of losses of one year in computing the income of the next. Those in receipt of income from overseas property will therefore have to take steps to ensure that income - or deemed income - from the overseas Schedule A business for the time being equals or exceeds expenditure. This is a fact to be taken into account in determining whether or not to incur expenditure on repairs to overseas property and will affect decisions on whether or not to claim capital allowances relating to expenditure. In the interim, reliance may still be placed on the concessionary relief found in Extra-Statutory Concession B25 which allows a carry forward of Case V losses from lettings set off against future income from the same property. It remains to be seen whether the Revenue will extend this concession to a loss generated by a payment of interest. *Ockenden v Mackley* may have a brief respite yet.

Clause 35(6) will also assist United Kingdom residents having an overseas domicile who remit sums representing income from a "source" outside the United Kingdom in a year of assessment after the source has ceased. Land overseas, as a source of income in the form of rent, normally ceases to exist as a "source" of such income in the hands of the non-domiciliary when the land is sold. The new requirement that all transactions or actions involving the exploitation of land overseas be treated as one business raises difficulties for non-domiciliaries minded to escape the charge to tax under Case V of Schedule D by remitting sums representing income after a parcel of land producing the income has been sold. For so long as the United Kingdom domiciliary retains any land as a source of

[24] The grant of a lease out of overseas land at a premium - without reserving a rent - does not bring the "source" of income represented by the land to an end. For so long as an interest in the land is retained by the taxpayer granting the lease that interest will continue to form part of his deemed Schedule A business.

income outside the United Kingdom he will be treated as retaining the source from which any remittances arose whether derived from that land or from land which has been sold But since the new regime requiring all overseas land to be treated as a single source does not come into effect until 6th April 1997 remittances of sums representing income from overseas land sold prior to that date will not be caught.

Subject to the transitional provisions found in paragraphs 6 and 7 of Schedule 20 the Finance Act 1994, income arising from a deemed Schedule A business consisting of the exploitation of land overseas will be computed and assessed on the current year basis from 6th April 1995 onwards. This applies to all new sources (i.e, properties) acquired after 5th April 1994. Hitherto income from overseas land was assessed on the basis of the income arising or (in the case of persons not domiciled in the United Kingdom) received in the United Kingdom during the preceding year of assessment. The preceding year basis of assessment is preserved for the year 1995-96 for sources of rental income existing on 6th April 1994 and the transitional and averaging provisions in paragraphs 6 and 7 of Schedule 20 to the Finance Act 1994 applying generally to Schedule D income will apply in the assessment of rental income under Case V of Schedule D.

The requirement that the income from an overseas "Schedule A business" is to be computed in accordance with the principles applicable to actual Schedule A businesses in the United Kingdom has necessitated consequential adaptations of the provisions of Schedule 8 to the Taxation of Chargeable Gains Act relating to lease premiums. These do not call for comment here.

There is nothing in the new rules to displace the provisions of section 65 of the Taxes Act under which the Case V income of United Kingdom residents who have retained a domicile outside the United Kingdom is to be taxed on the basis of income remitted to the United Kingdom. The new rules will, however, apply in the computation of the Case V income from land outside the United Kingdom so as to determine whether that which such non-domiciled person receives in the United Kingdom in the year of assessment is in fact income.

Do the computational provisions applying to overseas rents and other income or deemed income affect the computation of the income of non-residents in cases in which a United Kingdom resident may have an interest in such income - say, as the beneficiary under a trust or as a person having "power to enjoy" such income?[25] There is no ground for extending the decision in *IRC v Regent Trust Limited* (1980) STC 140 to bring the rental income derived from overseas property by non-resident trustees of an accumulation and discretionary settlement within the

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[25] See ss.686, 739 and 740 of the Taxes Act.

additional rate charge of 10% imposed by section 686 of the Taxes Act.[26] Such income is not taxable at the basic rate in their hands and will not therefore bear tax at the additional rate. So far as section 739 of the Taxes Act is concerned (under which a United Kingdom resident "transferor" with "power to enjoy" the income of a non-resident is to be charged to tax on the income of that non-resident), the better view[27] is that since the section requires the income of a non-resident to be treated as the income of the person having "power to enjoy", the income of the non-resident from overseas land is to be computed as for the purposes of Case V of Schedule D. So income deemed to arise from lease premiums on the grant of leases of land overseas will be included and interest and other expenses will be deductible.[28] Individuals, not being transferors, are chargeable under section 740 by reference to "benefits" received which are matched with "relevant income". It is an open question as to whether "relevant income" means that which would be taxable income if it had been the income of a United Kingdom resident or "income" in the hands of the non-resident recipient under the law of the country where it arises. If the latter is the correct interpretation, "relevant income" will not include the Schedule A income element in premiums and analogous sums paid on the grant or other exploitation of leases of land outside the United Kingdom. It would also be doubtful in such a case whether "relevant income" would necessarily be the sum obtained after deduction of expenses (including interest) allowed in computing the income as profits from a deemed Schedule A business or the sum of "income" calculated in accordance with the law of the country where the property is situate.

COLLECTION - NON-RESIDENTS

Until 5th April 1996 provisions providing for the deduction of tax at source from rents paid to non-residents (section 43 of the Taxes Act) will remain as reported. One effect of the changeover to the new system under which tax is to be charged on net profits and gains of a Schedule A business is that section 43, applying as it does to gross rents, is obsolete. So that section will not apply to any payment made after 5th April 1996. This has in its turn spawned a new section 42A of the Taxes Act 1988.[29] This applies both for the purposes of corporation tax and income tax. So it also affects the very small minority of non-resident companies which are within the charge to corporation tax in respect of rents or profits from land in the United Kingdom.

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26 It is not "income" of the overseas trustees for the purposes of the Income Tax Acts.

27 Supported by *Chetwode v IRC* [1977] STC 64.

28 Compare s.743(2) of the Taxes Act.

29 Clause 35 Finance Bill.

The new section 42A provides for the collection of tax in respect of rents and profits of a Schedule A business from tenants and from agents collecting rents or otherwise managing United Kingdom estates. The essential point to bear in mind is that the section is an enabling section conferring a regulation making power on the Board of Inland Revenue, rather than one having immediate effect. With modest exceptions, such as a provision conferring an express statutory right of indemnity on the tenant or collecting agent paying the tax, the new provisions are dependent on the Board making specific provision for the matters stated in regulations. In particular, specific provision will be needed to cater for the fact that the charge under Schedule A is on the profit of the Schedule A business not on gross rents less deductions. There is a mismatch between these provisions and the requirement that all Schedule A activities in the United Kingdom should be treated as one business in that there is no limit imposed on the liability of the tenant paying the rent or the collecting agent collecting the rent to account for tax. So the new section in its present form cannot be regarded as satisfactory - apart altogether from the wisdom of entrusting the Revenue with the extensive regulation powers conferred by the section.

The introduction of the new section 42A also means that it has been thought possible to dispense with section 23 (collection of tax from agents). The only agent now likely to be made liable is the agent for the non-resident under the new section 42A.[30] This is likely to have a significant impact on the manner in which the owners of holiday homes not falling within section 503 which are let out on a large scale organise their business. Previously the reporting of - and in some cases settlement of - tax liabilities in respect of holiday lettings has been left to the agent. Now, unless the owner is non-resident, the agent will have no responsibility for his principal's tax affairs. The repeal of section 23 has effect from 6th April 1995.[31]

CORPORATION TAX

Now that interest paid on loans to defray money applied in the purchase or improvement of commercially let property is to be treated, for the purposes of income tax, in the same way as interest paid on a loan raised by a taxpayer for the

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30 s.42A does not expressly exclude s.78 Taxes Management Act 1970 but this can be done by regulations. Clause 113 and Sched 23 to the Finance Bill only apply to trades, professions and vocations.

31 The fact that tax may be deducted at source and accounted for by the tenant paying the rent does not bring rental income from UK land within the definition of "excluded income" excepted from the charge to income tax in the hands of the non-resident by clause 115 of the Finance Bill. The Sched A income of a non-resident, in common with income assessable under Cases I and II of Sched D, but in contrast to, for example, UK company distributions and annual interest, remains potentially assessable to tax at higher rates.

purposes of his trade, such of the provisions of sections 353, 354 and 355 of the Taxes Act as permitted the deduction of interest in arriving at assessable Schedule A income in respect of commercially let property (as distinct from principal private residences) are considered redundant. Accordingly, clause 36 of the Finance Bill amends the Taxes Act 1988 by formally abolishing all interest relief for commercially let properties. Certain provisions (in particular section 355(4) dealing with the carry forward of interest exceeding the rents for one year to a later year) are preserved for income tax purposes for the transitional period to avoid any loss of relief as a consequence of the abolition.

It would not have been beyond the bounds of human ingenuity to have limited the repeal to income tax and to provide for the consequential amendment of section 355 (and section 338(6) dealing with charges on income) so as to adapt the provisions to corporation tax. The Revenue have opted instead to provide for companies with a new section 338A of the Taxes Act found in Schedule 7 to the Bill). This applies to accounting periods ending after 31st March 1995. It will be immediately apparent that this new section 388A has an affect identical to that of the old section 355(1)(b) and the provisions ancillary thereto.

It will still only be necessary to rely on this specific provision giving interest-relief in a limited class of case. In particular, interest payments made by a company which exists wholly or mainly for the purpose of carrying on a trade, interest wholly and exclusively laid out for the purpose of a trade carried on by any other company and interest payments made by an investment company will qualify as charges on income for corporation tax purposes provided the interest satisfies the conditions found in section 338(3) (yearly interest or interest on advances from a United Kingdom bank), section 338(4) (yearly interest paid to non-residents), and section 338(5) (payment under a liability for valuable and sufficient consideration). Given the fact that a high proportion of companies carrying on a business involving the commercial letting of properties will be investment companies, only a small minority will have to rely on the new section 338A - typically, one suspects, companies owning single properties let to individuals as a main residence.

Non-resident companies which are exceptionally within the charge to corporation tax will be subject to the new regime for collection of tax with effect from 6th April 1996 under the regulations made by the Board under the authority of the new section 42A of the Taxes Act (see above). Presumably the regulations will themselves address the problem occasioned by the fact that corporation tax is to be charged by reference to accounting periods - rather than years of assessment. Until 6th April 1996 the subsisting mechanism for the collection of tax chargeable on non-residents continues to apply (section 43 of the Taxes Act).

This brings one back to the least satisfactory aspect of the changes. This is the preservation of the existing computational rules for the purposes of corporation tax. For the Revenue and for professionals with neatly divided specialisations between personal taxation on the one hand and corporate taxation on the other this may present no great hardship. The problem for the professional will come when explaining to his individual clients who already hold property as individuals why the Schedule A profits of the company which they wish to use as an investment vehicle are to be computed on a different basis from the like profits arising from property held by them as individuals.

Transition

The intention is that the new code governing the computation and assessment of income under Schedule A will have effect for the year of assessment 1995-96[32]. Taxpayers under the self-assessment regime will therefore include particulars of Schedule A income arising in the year 1995-96 and computed in accordance with the new rules in their returns for 1996-97 (the filing date being 31st January 1998).

To the foregoing there are exceptions, to which some allusion has been made. The new regime does not apply where a source of Schedule A or Case VI Schedule D, income existed and was chargeable to tax for the year 1994-95 and ceased (without any separate commencement of a new Schedule A business in 1995-96) in the course of the year 1995-96 (clause 33(5) of the Finance Bill). The number of cases to which clause 33(5) applies may be small but not insignificant. The subsection would apply where, for example, a landlord disposed of several buildings from which he derived a rental income in 1994-95 in the course of the year 1995-96. Under the new regime all the buildings held by the same landlord for letting purposes would constitute a single source of income. Under the old regime, however, each premises constitute a separate source. For persons in the position of such a landlord the old regime will remain relevant in the year 1995-96.

The Revenue have also disclosed[33] the practice they propose to adopt in assessing or agreeing assessments of income under the self assessment regime for the transitional period where, as is often the case, the practice of individual taxpayers and Inspectors of Taxes has been to compute income assessable under Schedule A otherwise than in accordance with the strict principles and otherwise than by reference to income arising in the current year basis of assessment prescribed in Schedule A. The practice direction to Inspectors in these guidance notes is intended to facilitate the introduction of the self assessment regime; it presents little or no opportunity for minimising or avoiding the charge under Schedule A.

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32 Clause 33(4) of the Finance Bill.

33 Simon's Tax Intelligence 1995, p 250.