Annoying algorithms

Tim Good examines the rules for the deduction of a landlord's finance costs and considers whether HMRC's interpretation of these accords with the legislation.

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Calculating the amount of tax relief for a landlord's finance costs should be straightforward, but do HMRC know how to do it? Let's approach the subject as an examination question and to make it as easy as possible it will be an open book exam. Oh – and it'll be multiple choice. To spice things up, our fictional client could benefit by several thousand pounds if we get things right. The question concerns the tax liability for our client, Ms Byta Lett, on the basis of the following information for 2019-20.

	£
Net rental before finance costs	75,000
Property business finance costs	64,000
Gross interest income	45,000
Dividend income	100,000
Qualifying loan interest expense	50,000

The possible answers are:
(a) tax payable is £36,574; or
(b) tax payable is £44,374.

The relevant legislation

There are several statutory provisions that will determine the right answer:

- ITA 2007, s 23
- ITA 2007, s 25(2)
- ITA 2007, s 26(1)(a)
- ITTOIA 2005, s 274A
- ITTOIA 2005, s 274AA(1) to (3) and (6)

Key points

- Unrelieved finance costs may generate a tax reduction.
- The relevant legislation in ITTOIA 2005 and ITA 2007.
- Working through the tax calculation steps.
- Calculating the loan interest tax reducer.
- Does HMRC follow ITTOIA 2005, s 274AA(6)?
- The policy objective of the legislation.

Perhaps we should set out the legislation as the starting point and it might be worth having a copy alongside when we move to the liability calculations.

ITA 2007, s 23

ITA 2003, s 23 is headed 'The calculation of income tax liability' and reads as follows:

'To find the liability of a person ('the taxpayer') to income tax for a tax year, take the following steps.
Step 1: Identify the amounts of income on which the taxpayer is charged to income tax for the tax year.
The sum of those amounts is 'total income'.
Each of those amounts is a 'component' of total income.
Step 2: Deduct from the components the amount of any relief under a provision listed in relation to the taxpayer in s 24 to which the taxpayer is entitled for the tax year.
See ss 24A and 25 for further provision about the deduction of those reliefs. The sum of the amounts of the components left after this step is 'net income'.
Step 3: Deduct from the amounts of the components left after Step 2 any allowances to which the taxpayer is entitled for the tax year under Chapter 2 of Part 3 of this Act . . . (individuals: personal allowance and blind person's allowance).
See s 25 for further provision about the deduction of those allowances.
Step 4: Calculate tax at each applicable rate on the amounts of the components left after Step 3.
See Chapter 2 of this Part for the rates at which income tax is charged and the income charged at particular rates.
If the taxpayer is a trustee, see also Chapters 3 to 6 and 10 of Part 9 (special rules about settlements and trustees) for further provision about the income charged at particular rates.

See also ITTOIA 2005, s 863I which provides for certain partnership profits to be charged at the additional rate.

Step 5: Add together the amounts of tax calculated at Step 4.

Step 6: Deduct from the amount of tax calculated at Step 5 any tax reductions to which the taxpayer is entitled for the tax year under a provision listed in relation to the taxpayer in s 26.

See ss 27 to 29 for further provision about the deduction of those tax reductions.

Step 7: Add to the amount of tax left after Step 6 any amounts of tax for which the taxpayer is liable for the tax year under any provision listed in relation to the taxpayer in s 30.

The result is the taxpayer's liability to income tax for the tax year.'

ITA 2007, s 25

ITA 2003, s 25 is headed 'Reliefs and allowances deductible at Steps 2 and 3: supplementary' and the first two subsections are as follows:

(1) This section supplements the provisions about reliefs and allowances in Steps 2 and 3 of the calculation in s 23.

(2) At Steps 2 and 3, deduct the reliefs and allowances in the way which will result in the greatest reduction in the taxpayer's liability to income tax.

ITA 2007, s 26

ITA 2003, s 26 is headed 'Tax reductions'. We are interested in s 26(1)(a) which states:

(1) If the taxpayer is an individual, the provisions referred to at Step 6 of the calculation in s 23 are: the following … ITTOIA 2005, s 274A (property business: relief for non-deductible costs of a dwelling-related loan).'

ITTOIA 2005, s 274A

ITTOIA 2005, s 274A is headed 'Reduction for individuals: entitlement' and this (along with s 274AA below) falls within Pt 3 ('Profits (Property Businesses)') under a group of sections headed 'Tax reductions for non-deductible costs of a dwelling-related loan'.

Section 274A(1) states:

(1) If for a tax year an individual has:

(a) a relievable amount in respect of a property business; or

(b) two or more relievable amounts each in respect of a different property business;

the individual is entitled to relief under this section for that year in respect of that relievable amount or (as the case may be) each of those relievable amounts.'

ITTOIA 2005, s 274AA(1) to (3) and (6)

ITTOIA 2005, s 274AA is headed 'Reduction for individuals: calculation'. Here, we must focus on ss (1) to (3) and ss (6):

(1) This section applies if for a tax year an individual is entitled to relief under s 274A in respect of a relievable amount or in respect of each of two or more relievable amounts, and in the following subsections of this section 'relievable amount' means that relievable amount or (as the case may be) any of those relievable amounts.

(2) In respect of a relievable amount, the actual amount on which relief for the year is to be given is (subject to subsection (3)) the amount ('L') that is the lower of:

(a) the relievable amount; and

(b) the total of:

(i) the profits for income tax purposes of the property business concerned for the year after any deduction under ITA 2007, s 118 ('the adjusted profits') or, if less, the share (if any) of the adjusted profits on which the individual is liable to income tax otherwise than under Pt 5 Ch 6; and

(ii) so much (if any) of the relievable amount as consists of current-year estate amounts.

(3) If S is greater than the individual's adjusted total income for the year (ATI), the actual amount on which relief for the year is to be given in respect of a relievable amount is given by: (ATI/S) x L where:

S is the total obtained by identifying the amount that is L for each relievable amount and then finding the total of the amounts identified; and

L has the same meaning as in ss (2).

(6) For the purposes of this section, an individual's adjusted total income for a tax year is identified as follows:

Step 1: Identify the individual's net income for the year (see Step 2 of the calculation in ITA 2007, s 23).

Step 2: Exclude from that net income:

(a) so much of it as is within ITA 2007, s 18(3) or (4) (income from savings); and

(b) so much of it as is dividend income.

Step 3: Reduce what is left after Step 2 of this calculation by the amount of any allowances deducted for the year in the individual's case at Step 3 of the calculation in ITA 2007, s 23. The result is the individual's adjusted total income for the year.

The analysis

This question is all about how to allocate the qualifying loan interest of £50,000 (to comply with ITA 2007, s 25(2)) and how to calculate the 'adjusted total income' (ATI) under ITTOIA 2005, s 247AA. The qualifying loan interest would be for one of the reasons under ITA 2007, s 383 to s 412; for example, to buy an interest in a close company – which might be the source of the dividend income in this example.

The legislation cited above makes it clear that the tax reducer for disallowable property finance costs provided for by ITTOIA 2005, s 274A is, by virtue of ITA 2007, s 26, deducted as part of Step 6 in arriving at the tax liability in Step 7 of s 23.

By 'tax reducer' I mean, of course, basic rate income tax on that element of the property finance costs that is not relieved as a straightforward deduction from property income.

My calculation

Calculate the taxable property business profits by deducting 25% of the £64,000 property business finance costs (£16,000) from the net rentals of £75,000 to give taxable property business profits of £59,000. The other £48,000 of the finance costs is what s 274A describes as the 'relievable amount'.

Now allocate the £50,000 loan interest (note there will be no personal allowance available) £5,000 to the £59,000 taxable property business profits and the other £45,000 to the interest income of £45,000. This allocation results in a tax figure (Step 5 of ITA 2007, s 23) of £46,174 (see ***Step 5 calculation***).

Next, we must calculate the tax reducer amount under ITTOIA 2005, s 274A.

The tax reducer (see ITTOIA 2005, s 274AA(2) to (3)) must be calculated by taking 20% of the lowest of:

(1) the property finance costs no longer allowed as an expense;
(2) the taxable property profits; and
(3) the ATI.

We already know that 1 is £48,000 and 2 is £59,000 so that just leaves the ATI – the adjusted total income.

Calculating the ATI

Let's follow the step by step instructions in ITTOIA 2005, s 274AA(6) ITTOIA 2005.

First, Step 1: Identify the individual's net income for the year (see Step 2 of the calculation in ITA 2007, s 23).

So we return to s 23 where the Step 1 'components' are:

	£
Property business profits	59,000
Gross interest income	45,000
Dividend income	100,000

The relief allocation (£5,000 to the £59,000 taxable property business profits and the other £45,000 to the interest income of £45,000) then gives us the s 23 Step 2 components as:

	£
Property business profits	54,000
Gross interest income	nil
Dividend income	100,000
Section 23 Step 2 net income	154,000

We now move to s 274AA(6), Step 2:

Exclude from that net income:

(a) so much of it as is within ITA 2007, s 18(3) or (4) (income from savings); and
(b) so much of it as is dividend income.

The net income includes £nil interest income and £100,000 dividend income. Excluding those will leave ATI of £54,000.

The tax reducer (see s 274AA(2) to (3)) must be calculated by taking 20% of the lowest of:

(1) £48,000 – the property finance costs no longer allowed as an expense;
(2) £59,000 – the taxable property profits; and
(3) £54,000 – the adjusted total income (ATI).

The conclusion is that the tax reducer under s 274AA will be £9,600 (20% of £48,000) and the final tax liability under ITA 2007, s 23 will be £36,574 (being £46,174 – £9,600).

It appears answer (a) is the correct multiple choice selection.

HMRC's calculation

Very simply, HMRC has programmed its calculator to work out the ATI as the excess of non-savings income over allowances and reliefs as follows:

	£	£	£
Net income		£154,000	
Savings income		£45,000	
Dividend income		£100,000	
Allowances		£0	
Adjusted total income		£9,000	
Total finance costs	£48,000		
Allowable amount			£48,000
Relievable amount			£9,000

HMRC maintains that the way in which allowances and reliefs are allocated in ITA 2007, s 23 has no relevance to the calculation of ATI. The department's analysis is that the tax reducer is calculated by taking 20% of the lowest of:

(4) (1) £48,000 – the property finance costs no longer allowed as an expense;
(5) (2) £59,000 – the taxable property profits; and
(6) (3) £9,000 – the adjusted total income (ATI).

HMRC's conclusion is that the tax reducer under ITTOIA 2005, s 274AA will be 20% of £9,000 (£1,800) and the final tax liability under ITA 2007, s 23 will be £44,374 (calculated as £46,174 – £1,800).

HMRC thinks that answer (b) – £44,374 – is the correct multiple choice selection to the tax liability.

Step 5 calculation

	Rent	*Interest*	*Dividend*
	£	£	£
Gross income	75,000	45,000	100,000
Less: Finance costs (£64,000 x 25%)	16,000		
	59,000		
Less: Qualifying loan interest	5,000	45,000	
	54,000	0	100,000
No personal allowances due to income level			
Taxed as follows:			
£37,500 x 20% =	7,500		
16,500 x 40% =	6,600		
2,000 x 0% (dividend tax allowance) =			0
94,000 x 32.5% =			30,550
2,000 x 38.1% =			1,524
	14,100		32,074
	32,074		
ITA 2007, s 23 – Step 5	46,174		

Which answer is correct?

Ultimately, this will have to be decided by the tax tribunal, but here are the key arguments against HMRC's approach.

(1) HMRC does not follow the step-by-step approach set out in ITTOIA 2005, s 274AA(6).
(2) If the legislation drafter had intended the HMRC methodology, they could more easily have defined the ATI as: 'The excess of the taxpayer's non-savings income over the reliefs and allowances available under ITA 2007, s 24 and s 25.'.
(3) The s 274AA relief is given as a deduction in Step 6 of ITA 2007, s 23 and can therefore influence the allocation of reliefs and allowances as directed under ITA 2007, s 25.

Of course, the application of s 25 has long been a problem for the programmers who code the HMRC tax calculator and even now the HMRC calculations of tax for 2019-20 are wrong for taxpayers with various combinations of different types of income.

However, the error that HMRC makes for landlords is quite simple. The department's calculator allocates allowances and reliefs in a way that minimises the tax *before* the finance cost tax reducer whereas s 25 directs us to minimise the tax *after* the tax reducer. It then works out the ATI using their simplified method.

That makes two simple errors.

What does HMRC say about this?

I first emailed HMRC about this issue on 4 June 2018 (yes – more than two years ago). The most recent response from the department was on 27 May 2020 and is (largely) reproduced below:

> 'The second issue surrounded the interpretation and interaction of ITTOIA 2005, s 274AA(6) and ITA 2007, s 23. As part of the calculation for finance costs relief, the customer's adjusted net income is calculated. Specifically, s 274AA(6) provides that at Step 1 "Identify the individual's net income for the year (see Step 2 of the calculation in ITA 2007, s 23)." Step 2 of ITA 2007, s 23 provides: "Deduct from the components the amount of any relief under a provision listed in relation to the taxpayer in s 24 to which the taxpayer is entitled for the tax year. See s 24A and s 25 for further provision about the deduction of those reliefs. The sum of the amounts of the components left after this step is 'net income'. Specifically, s 25(2) then provides that "At Steps 2 and 3 [of s23], deduct the reliefs and allowances in the way which will result in the greatest reduction in the taxpayer's liability to income tax." As s 274AA directs to Step 2 of s 23, it could be argued that Step 2 must be undertaken in full, including any further sections or subsections that Step 2 refers to, in this case ss 24A and 25 that allow the allocation of reliefs in the most advantageous way for the taxpayer.
>
> 'It was this issue in particular that has taken so much time to work through, in conjunction with our colleagues in our Solicitors' Office, but we can now clarify HMRC's position. We believe that it is crucial to acknowledge that s 274AA(6) is there to identify an individual's "adjusted total income", not their liability to tax, and step 1 of s 274AA(6) is concerned with identifying their "net income" and references step 2 of the calculation in ITA 2007, s 23, (which instructs us to deduct reliefs at ITA 2007, s 24, referencing ITA 2007, ss 24A and 25), only as a point of reference as to where to find that "net income". This net income figure will be identical, irrespective of how reliefs are allocated, and on that point we all agree. Where a divergence has occurred is whether or not we should read in to Step 1 of s 274AA(6) that the "net income" figure is broken down into its components with reliefs allocated in a way that would later result in the increase of relief due, reducing the individuals' overall liability to income tax. HMRC believe we should not read that into step 1 of s 274AA(6).
>
> 'Step 2 of s 2744AA(6) then instructs us to deduct from net income savings and dividends. HMRC believe the purposive interpretation of this step is to remove savings and dividends from "net income". This figure of net income is taken from Step 1 of s 274AA(6), and not the components of net income with reliefs allocated in a particular order. Whilst Step 1 of s 274AA(6) does refer to Step 2 of the calculation in ITA 2007, s 23, Step 2 of ITTOIA 2005, s 2744AA(6) does not, and so it should follow that neither does it invoke ITA 2007, s 25(2).
>
> 'The ITTOIA 2005, s 274AA calculation should be undertaken outside of ITA 2007, s 23 and then feed the result in to s 23 at Step 6 as a tax reducer listed at ITA 2007, s 26. It is a side calculation for the purposes of calculating the tax reducer only and so it should not be included within s 23 with the resultant circular calculation this would invoke.
>
> 'HMRC believe that the expectation was that any reliefs and allowances would be deducted from non-savings income first. It was expected the s 23 Step 2 income would have the reliefs deducted from other types of income before they are deducted from savings and dividend income. Indeed, it can actually be seen to be more beneficial in the long term for a customer, as doing so can in some circumstances allow more unused relief to be carried forward. It was also expected the s 23 Step 3 allowances would not be deducted from savings and dividend income and this is defined in s 274AA(6) Step 3 as being set against net income after excluding savings and dividends. The personal allowance and blind persons allowance cannot therefore be set against the savings and dividend income and can only reduce the amount of other income.
>
> 'Finally, for finance relief under s 274AA the self-assessment tax calculator allows equal treatment of the reliefs and allowances at s 23 Step 2 and Step 3 respectively. If the intention of s 274AA had been to identify the components after relief then s 274AA would have made that clear in Step 1 and Step 2.'

I must leave to the reader to make of this what they will, but I would point out that:

(1) Step 2 of s 2744AA(6) does not 'instruct us to deduct from "net income" savings and dividends'. It instructs us to 'exclude from that net income so much of it as is … savings income and … dividend income'.
(2) The assertion that the s 274AA(6) calculation should be done outside the s 23 calculation cannot be right when the

s 23 calculation depends on the deduction of the s 274A tax reducer at Step 6.

(3) The statement by HMRC that: ‘It is a side calculation for the purposes of calculating the tax reducer only and so it should not be included within s 23 with the resultant circular calculation this would invoke’ perhaps gives the game away. The HMRC calculator is, in essence, a massive Excel spreadsheet and it is (I think) impossible to write a single algorithm that complies with the legislation without introducing a fatal circularity into the spreadsheet. My own Excel calculator resolves this circularity problem by using no fewer than 12 different algorithms to allocate allowances and reliefs and then selecting the version that gives the lowest s 23 tax liability.

(4) The policy objective? In earlier correspondence on this issue HMRC stated: ‘The intention of the comparison with ATI is so that finance costs cannot create a repayment of tax. It can only reduce what is already owed.’ Although the policy objective is irrelevant to the application of clear, unambiguous legislation that is not absurd, I would point out that in neither my nor HMRC’s application does the finance cost tax reduction generate a repayment of tax. Nor do my calculations ever result in a finance cost tax reduction that exceeds the tax attributable to the taxable property profit.

Other examples

For those who might think that my example is contrived, I must say that there are many different combinations of income and reliefs that can give rise to a material difference between the tax that HMRC and (probably) the adviser’s software will calculate and what I maintain is the correct tax. Here is just one other example (perhaps a director/shareholder with a rental property):

	£
Employment income	10,000
Net rental before finance costs	34,000
Property business finance costs	30,000
Dividend income	14,000
Qualifying loan interest expense	24,000

As shown in ***Calculation***, I calculate the 2019-20 liability as £150 whereas HMRC calculates it as £900. A difference of £750.

Identifying affected clients and taking action

If a landlord client has some sort of relief (qualifying loan interest, loss relief and the like) *and* the tax reducer calculated by commercial software is less than 20% of the disallowed property finance costs, this might be a case worth pursuing (although not every such case will be).

My advice to Ms Byta Lett is to appeal to the First-tier Tribunal. HMRC is not going to give way on this without a hearing. Interestingly, the circumstances that have brought us to this are much the same as those leading up to the successful outcome for the taxpayer (and many others) in *Marina Silver* (TC7103): the drafter drafts statutory provisions which although clear and unambiguous engage the limitations of Excel and force the programmers at HMRC to take short cuts, which then act to the detriment of the taxpayer. ●

Calculation

	Earnings	*Rent*	*Dividend*
	£	£	£
Gross income	10,000	34,000	14,000
Less: Finance costs (£30,000 x 25%)		7,500	
		26,500	
Less: Personal allowance	10,000	2,500	
	0	24,000	
Less: Qualifying loan interest (£24,000)		14,000	10,000
		10,000	4,000
Taxed as follows:			
£10,000 x 20% =		2,000	
2,000 x 0% (dividend tax allowance) =			0
2,000 x 7.5% =			150
Less: tax reducer (£10,000 x 20%)		2,000	0
Net liability		0	150
Notes:			
Tax reducer = Lower of:			
Property finance disallowed (£30,000 – £7,500)			£22,500
Taxable property income			£26,500
ATI			£10,000

HMRC’s calculation allocates the qualifying loan interest of £24,000 in full against the net rental income. This leaves £14,000 of dividend income in charge with a liability of £900 (£2,000 x 0% and £12,000 x 7.5%).

Planning point

If a landlord is claiming relief such as loan interest or loss relief and the tax reducer is less than 20% of the disallowed property finance costs, the tax calculations should be checked carefully.

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