

RENTAL PROPERTIES AND THE RENEWALS BASIS – AN UPDATE

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Rental property and the renewals basis – an update

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Introduction

Prior to 6 April 2013, the landlord of a furnished residential property had a choice when he came to replace items in the house or flat. He could claim the renewals basis. Alternatively, he could claim a wear and tear allowance, calculated as 10% of the net rent, ie. rent less expenses such as utilities, council tax and anything else for which the tenant is usually responsible. In practice, the 10% wear and tear allowance, which is a statutory claim under Ss308A – 308C ITTOIA 2005, was normally preferred.

If the property was not fully furnished (for example, if it only contained kitchen appliances), the 10% wear and tear allowance is not available – see S308B ITTOIA 2005. The renewals basis would have been the only option in these circumstances.

This renewals allowance worked on the basis that one cannot have a tax deduction for the first purchase of a piece of equipment. Instead, when that item needed to be replaced, the cost of the replacement could be claimed as a renewal. Thus, if an individual was fitting out a new rental property, there was no relief for the expense of buying a cooker or fridge-freezer. However, when, say, the fridge-freezer was replaced, the cost of the new one represented an allowable deduction.

Following the publication of a technical note on 6 December 2011, HMRC announced that the renewals basis would not be available for replacement expenditure on plant or equipment which was incurred on or after 6 April 2013. With effect from that date, the sole relief available to residential landlords is the 10% wear and tear allowance and, because this can only be claimed in connection with fully furnished properties, it follows that landlords of unfurnished (or partly furnished) residential accommodation cannot claim relief for the cost of replacing items such as cookers, fridges, dishwashers and so on.

There is, however, an argument which maintains that equipment such as cookers and other white goods qualify as 'trade tools' under S68 ITTOIA 2005 so that their costs are deductible by virtue of statute. If so, the loss of the renewals basis would be less of a problem. S68 ITTOIA 2005, which deals with replacement expenditure, reads as follows:

- '(1) This section applies if:
- (a) expenses are incurred on replacing or altering any tool used for the purposes of a trade; and
 - (b) a deduction for the expenses would not otherwise be allowable in calculating the profits of the trade because (and only because) they are items of a capital nature.
- (2) In calculating the profits of the trade, a deduction is allowed for the expenses.
- (3) In this section "tool" means any implement, utensil or article.'

Given that *Caledonian Railway Co v Banks* (1880) established that rolling stock could be treated as what are now called 'trade tools', it seems not unreasonable to extend that argument to cookers and fridges in a partly furnished rental property. Having said that, the

position was by no means clear and so a letter sent to HMRC on 4 February 2014 under the joint auspices of the CIOT and the Tax Faculty requested clarification of the position.

HMRC replied on 7 April 2014 and there are elements of their response which are encouraging. For example, they confirm that the more expensive built-in appliances are regarded as fixtures and so are deductible as repairs – in other words, they are dealt with under the normal rules for fixtures, ie. replacing a fixture without improving it beyond its original condition is allowable. However, HMRC did say that S68 ITTOIA 2005 does not give an alternative deduction for free-standing appliances such as fridge-freezers and for carpets or curtains. It would appear that smaller items which are regularly replaced, eg. toasters, crockery, cutlery and glassware, do fall within the definition of ‘trade tools’ in S68 ITTOIA 2005 and therefore are deductible under this provision. This is of course subject to the caveat that the landlord must not be claiming the 10% wear and tear allowance.

The following extract from the HMRC letter may be helpful:

‘S68 ITTOIA 2005 relates only to items of a capital nature that are of a relatively low value and have a short useful economic life that would need to be regularly . . . replaced in the ordinary course of business due to normal wear and tear. This would be on items such as crockery and rugs for instance, ie. low-cost soft furnishings that might be expected to be replaced fairly regularly. However, it would not apply to carpets, for instance, as they are a capital item of potentially higher value that you would not expect to replace regularly. However, landlords may be able to get some relief on carpets if the expenditure qualifies as a revenue expense.

White goods such as washing machines and fridges are not covered by the statutory renewals allowance as they are capital items not part of the entirety (the property). However, where white goods are fitted (ie. integrated hobs and ovens), we recognise these as part of the entirety (the property) and so these would be deductible as a repair when replaced.

To confirm, therefore, anything free-standing such as a fridge-freezer will not become part of the entirety (the property) for residential lettings and therefore would not be deductible under S68 ITTOIA 2005.’

The reference to a ‘statutory renewals allowance’ is to S68 ITTOIA 2005 and the official HMRC guidance on this section can be found in Para BIM46960 of the Business Income Manual. The case law dealing with the concept of an ‘entirety’ can be found at O’Grady v Bullcroft Main Collieries Ltd (1932) and Samuel Jones & Co (Devondale) Ltd v CIR (1951).

A recent development

Following the submission of the latest set of tax returns, the impact of the withdrawal of the renewals basis for 2013/14 onwards is only now being realised by landlords. In conjunction with the CIOT, the Tax Faculty asked the Residential Landlords Association to survey their members earlier this year in order to discover:

- (i) whether landlords were aware of this change in the tax rules;
- (ii) if the change would impact on the frequency with which they will be replacing white goods, carpets and curtains; and
- (iii) whether or not they would be reorganising their businesses so that they move away from having partly furnished lets to being fully furnished or totally unfurnished.

The results were very interesting. Of the 628 responses from landlords, over 75% were unaware of HMRC's removal of the renewals basis. A clear majority of landlords said that they currently provide:

- (i) white goods (74%);
- (ii) carpets (98%); and
- (iii) curtains (79%)

in their non-fully furnished rental properties and more than half confirmed that the lack of tax relief would have an effect on the frequency with which such items were replaced in the future.

Those landlords who change to having fully furnished lets will then be eligible for the 10% wear and tear allowance. This is likely to cost the Treasury more than allowing renewal costs for non-fully furnished lets. It is understood that the Tax Faculty will be taking this point forward.

Companies

These notes have been written from the perspective of an individual landlord, ie. one who is subject to income tax. For completeness, it should be made clear that the equivalent statutory provisions for corporate landlords are:

- (i) 10% wear and tear allowance (Ss248A – 248C CTA 2009); and
- (ii) statutory renewals allowance (S68 CTA 2009).

And, for companies, the renewals basis was abolished for expenditure incurred on or after 1 April 2013.