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Back to Basics: Case V Income - Rules of the Road

Introduction

In Leo Tolstoy's *How Much Land Does a Man Need?* (1886), a man's obsession with adding ever more land to a portfolio that currently provides him with a very comfortable living results in his untimely demise. In the end, the author reflects that, "six feet from his head to his heels was all he needed".

Accountants recognise the value of land by the fact it is not generally depreciated. Governments benefit from this value via property taxation. Landlords keep after-tax profits. In recent times it has been asked whether this is enough to keep landlords in the market. While property prices have in certain cases improved significantly since the property crash of 2008, the tax incentives available to private landlords have not.

In this back to basics review, we'll revisit the fundamentals of how case v income is calculated, outline the expenditure which continues to be tax deductible to the private landlord, and provide an overview of some of the areas in practice in which difficulties can arise.

How Case V Income Is Calculated

As TCA 1997 does not come with a Case V pro forma calculation template, it may be useful to start with the table below.

Table 1: Step-by-step guide to calculating Case V income.

Step-by-step guide	€
Rental income (i.e. gross rents)	X
Less rental expenses	(X)
Net rental income (i.e. aggregated surplus or deficiency)	**X**
Less Case V capital allowances*	(X)
Profits charged to tax	**X**
Less Case V losses carried forward	(X)
Assessable Case V income	**X**

* In certain cases, the Tax Acts require Case V capital allowances brought forward from earlier years to be used in priority to current year Case V capital allowances. See Tax and Duty Manual Part 15-02a-06 for further information on the order of offset of such allowances.

Basis of assessment

Case V profits are subject to tax on an "arising" rather than a receipts or accrual basis. Generally, if you can sue for receipt, income is said to have arisen.

Such profits are deemed to issue from a single source, i.e. the surplus or deficiency from each rental property is aggregated to arrive at net rental income.

To arrive at the aggregated figure, a separate computation (gross rent less rental expenses) is required for each letting, as uneconomic lettings must be excluded in the aggregation process. This seeks to prevent a landlord artificially creating a deficiency for use in the aggregation process. An uneconomic letting would include, for example, where a landlord lets a property to a relative for a peppercorn rent of €1. In this case, the landlord cannot include a deficiency arising due to rental expenses of the property exceeding gross rent.

Rental income

It is important to ensure in the first instance that you have identified correctly that the income is in fact Case V and not Case I or Case IV[1]. For example, income for providing short-term holiday lettings for occasional visitors such as through an online accommodation booking system is not considered rental income (Case V) and is taxable as "other income" (Case IV) if occasional income, or as "trading income" (Case I) if operated as a trade such as a guesthouse. In *Twomey v Hennessy* [2011] 4 IR 395, Laffoy J determined that for a payment to be categorised as rent there must be a landlord–tenant relationship. In general terms, a landlord–tenant relationship is created when a landlord grants to a tenant **exclusive** use of land or a part of a building in exchange for rent or valuable consideration. For further reading on this distinction, please refer to the recent Tax Appeals Commission determination 09TACD2020.

For Case V purposes, rental income broadly includes:

- rent in respect of any premises (e.g. land and buildings),
- receipts in respect of any easements (e.g. a right over land),
- certain lease premiums, including deemed and reverse premiums, and
- payments received from insurance policies (e.g. relating to Covid-19) that cover against the non-payment of rent.

The following payments in the nature of rent are also included:

1 See article by John Cuddigan "Taxing Income from the Provision of Accommodation: Learning from the Past", *Irish Tax Review*, 32/1 (2019).

- payments relating partly to goods or services (e.g. where the landlord provides a cleaning service as part of the letting arrangement) and
- a situation where the lessee pays for the costs of work to the premises that the lessee was not required to do under the lease.

As part of a commercial agreement to grant a lease, a landlord may be compensated by an upfront lump sum payment generally referred to as a premium. To protect against premiums being used as a means to reduce a landlord's income tax bill, a separate calculation is required to determine how much of any premium required to be paid under a short lease (i.e. a lease of less than 50 years) should be treated as rental income. This calculation may be best demonstrated by way of example.

Example 1: How to calculate portion of premium to be treated as rent.

Formula to be used: $P \times \frac{(51-N)}{50}$

P = Lease premium   N = The number of complete years in the term of the lease

A 21-year lease is agreed between a landlord a tenant that requires the payment of an upfront premium of €100,000 in addition to annual rent of €35,000.

Premium treated as rent:

$€100,000 \times \frac{(51-21)}{50} = €60,000$

The landlord should separately consider its CGT position with respect to the balance of the premium received.

Section 98 TCA 1997 also provides that the payments below are deemed to be premiums for this purpose:

- where under the terms subject to which a lease is granted a sum becomes payable by the lessee:
  - in place of all or part of the rent due for a period or
  - as consideration for the surrender of the lease (e.g. lease break cost);
- consideration paid by the lessee for the variation or waiver of any terms of a lease; and
- any sum other than rent paid on or in connection with the granting of a lease except in so far as other sufficient consideration is shown to have been given.

Determining whether a payment for surrender of a lease is a premium for Case V purposes can require significant technical analysis. Revenue notes in its Tax and Duty Manual Part 19-02-21: Leases that a surrender payment "**which is not made under the terms subject to which the lease is granted...should be treated as a part disposal of the lessor's interest**" (i.e. the entire receipt in this case may be subject to CGT rather than Case V). In practice, careful analysis is required to determine based on the facts what the nature of the payment is. This analysis then allows a determination to be made of how much is taxable as Case V income and how much is taxable as a capital gain.

It is common where a lease is surrendered by a tenant that a dilapidation payment becomes payable by the tenant to the landlord to cover the cost to the landlord of restoring the property to its original condition. In many cases this is considered a more practical solution to the tenant satisfying its lease obligations to the landlord than the tenant carrying out the repair work itself. To determine whether such dilapidation payments should be treated as rental income, it would be necessary to determine whether the payment should be regarded as a premium under s98 TCA 1997. Where the payment is not determined to be a premium, the landlord would further need to consider whether it is an income or a capital receipt. Revenue guidance is silent on this matter. Although it is not binding in an Irish context, HMRC's Property Income Manual 2040 provides useful commentary. The general rules outlined in this guidance are that:

- Where, following receipt of the dilapidation payment, the landlord disposes of the property or occupies it for personal use, the payment is likely to be treated as a capital receipt.

- Where the landlord uses the payment to carry out the necessary repairs, the landlord should get a rental deduction only for the net cost of carrying out the repair work.
- Other payments that have the effect of compensating the landlord for the lower rent that the property can now command (given its dilapidated condition) should be treated as rental receipts.

The general rule with respect to payments of a reverse premium (broadly, a payment by a landlord to induce a tenant to enter a tenancy) is that the payment should be viewed as revenue in nature and treated by the recipient as if it were an amount of rent. Exceptions to the general rule apply; for example, where the recipient is a person carrying on a Case I trade and the transaction is entered into for the purposes of the recipient's trade, the receipt should instead be taken into account as a Case I receipt.

Rental expenses

Section 97 TCA 1997 provides that the following costs are deductible in the calculation of rental profits provided always that such costs are revenue rather than capital in nature:

(a) rent payable by the landlord in respect of the property being let,

(b) rates levied by a local authority in respect of the property being let,

(c) costs that the landlord is obliged to incur under the lease,

(d) maintenance, repairs, insurance and management of the premises being let and

(e) interest on borrowings used for the purchase, improvement or repair of the premises.

Revenue has also stated that it is prepared to allow a deduction for mortgage protection policies that carry a decreasing term, accountancy fees for the purposes of preparing a rent account and the cost of registering with the Residential Tenancies Board (RTB). Interest payable on replacement borrowings is generally also acceptable provided the original borrowings satisfied condition (e) above.

In practice, interest payable tends to be a key area of focus. Difficulties faced here include:

- Interest payable in respect of rented residential premises is deductible only to the extent that a landlord can show that the property is registered with the RTB in the period in which the interest is payable.
- Where one spouse transfers a rented residential property to another spouse, the acquiring spouse is not entitled to a deduction for interest on borrowings to acquire the property.
- Where, due to the time taken to negotiate third-party finance, equity finance is used initially to fund the purchase of rental property, interest payable on a loan taken out to repay the equity finance will not qualify as tax-deductible under Case V.
- Interest payable for a period before the premises was first occupied by lessee (commonly referred to as pre-letting interest) is not deductible.
- Post-letting interest, where, for example, a rental property in negative equity was sold and a level of interest-bearing debt with respect to the property disposed of continues to be payable, is not deductible.

Helpfully, since 1 January 2019, Case V rules on interest deductibility no longer require a percentage restriction on the level of interest deductible on residential property lettings. Prior to this, a residential landlord could have an effective tax rate on rental profits in excess of 70% when non-deductible interest and expenses, income tax, USC and PRSI were accounted for.

Assistance has also been given in the area of pre-letting expenses. Before 1 January 2018, deductible pre-letting expenses generally consisted of advertising and legal costs of putting the letting in place. Now, pre-letting expenses incurred on a premises that has been vacant for 12 months that would have been deductible in respect of a rented premises can be deducted subject to a cap of €5,000 per vacant premises. Qualifying expenditure here that consists of interest payable overrides the previous occupied rule mentioned above. Note that the property must have been let by 31 December 2021 and the

deduction is subject to a clawback where the premises is not let within four years.

Revenue currently views local property tax (LPT) as non-deductible. The Interdepartmental Group on Property Tax established in 2012 and chaired by Dr Don Thornhill in its report on the design of the LPT has previously stated that "**[t]here would appear to be an equity argument for allowing, at least a portion of, LPT...paid in respect of a rented property to be deductible for tax purposes in the same way as commercial rates are deductible for tax purposes**". Thornhill's position was clarified in a later, 2015 report, which noted that "**a deduction should not be allowed on the basis that the concept of the LPT is linked to the amenity value of residential property which is of benefit to the tenant in addition to the landlord**".

Debt issuance costs such as arrangement fees can also represent a tax cost for landlords. Revenue's published guidance on this matter (Tax and Duty Manual Part 04-06-21: Tax Treatment of Debt Issuance Costs):

- accepts that costs of this nature incurred in connection with borrowings to acquire trading stock would be deductible in calculating trading profits and
- notes that where the borrowing (of the Case I trader) is applied for capital purposes (e.g. to repurchase share capital of the company), costs associated with the borrowing will not be deductible.

It is silent, however, on the Case V treatment for landlords who incur such costs on borrowings to acquire rental properties. As the rules on deductible rental expenses are more restrictive than those governing trading expenses, and debt issuance costs are not generally considered to be "interest", there is little to support a landlord's claiming debt issuance costs as deductible letting expenses.

Capital allowances

Once the aggregated surplus or deficiency has been identified, the deduction of capital allowances is the next step in the Case V calculation. Although most of the accelerated capital allowance schemes have long since been discontinued, it remains possible for landlords to claim wear-and-tear allowances (generally at a rate of 12.5% per year) on expenditure incurred on the provision of plant or machinery that is leased:

- with a furnished residential letting provided the premises is let on bona fide commercial terms in the open market and
- as part of a commercial letting where the plant or machinery is let on such terms that the burden of wear and tear falls directly on the lessor.

Helpfully, by concession, Revenue will accept allowances claimed in respect of plant or machinery that is let as part of a leased building to be offset against both the rental income of the building and the plant. Had this concession not been given, the taxpayer would be left in the unenviable position of having to identify the portion of the net rental income that relates to the leased plant or machinery and apply the wear-and-tear allowance against only this income.

In certain cases, landlords may also claim industrial building allowances on expenditure incurred in the construction or refurbishment of the building or structure (generally at a rate of 4% per year) where the landlord holds the relevant interest in the building and at the end of the chargeable period the tenant occupies the building as an industrial building. It is important that expenditure on the land on which the building is constructed or refurbished is excluded from the expenditure identified as qualifying expenditure for this purpose.

Involving a tax depreciation expert at an early stage of any build-to-let project can be a crucial value-add to taxpayers seeking to identify correctly expenditure qualifying for wear-and-tear allowances and that qualifying for industrial building allowances.

Within the capital allowances subset there can also be an order of priority between allowances brought forward from earlier years and current year allowances. A useful guide in this regard can be found in Tax and Duty Manual Part 15-02a-06: Order of offsets of reliefs, allowances and deductions.

Case V losses carried forward

A loss incurred in respect of a Case V letting can be carried forward indefinitely for use in future years. For taxpayers who are jointly assessed, it is not possible to use a Case V loss carried forward by one spouse to offset the rental profit of the other spouse.

For individuals, in some cases it may be more beneficial for a taxpayer to use a Case V loss carried forward to offset a Case V surplus rather than claim an industrial building allowance where the allowance is a specified relief the use of which is restricted by the high-income earner restriction.

As noted earlier, Case V allowances are deducted in charging profits to tax. This is before Case V losses carried forward are available for offset. An option remains for the taxpayer, however, as Revenue has stated (Revenue precedent IT953012) (which is republished in Tax and Duty Manual Part 15-02A-06) that where a taxpayer chooses not to claim an allowance (i.e. to disclaim it) this decision should be accepted by the relevant Revenue District.

As part of a cost/benefit analysis in deciding whether to disclaim an allowance in favour of using a loss carried forward, taxpayers would also need to factor in that capital allowances are deductible for PRSI purposes whereas a Case V loss carried forward is not. It should also be noted that the use of specified reliefs is subject to a USC property relief surcharge of 5%. Disclaiming an allowance carried forward would also be a cost to the taxpayer where that allowance is no longer available for use.

Relief for rent not received

In the midst of the current pandemic, it is worth noting also that relief is available to landlords for rent which the landlord was entitled to but has not received. Section 101 TCA provides a remedy by allowing landlords to make a tax refund claim where:

- the landlord can prove tax has been paid based on income which has not been received, **and**
- the non-receipt was due to default on the part of the tenant, **or**
- the landlord has waived the right to payment and that waiver was made without consideration and for the purpose of avoiding hardship.

Where subsequent to the refund claim being made, the landlord recovers any part of the rent due the tax due on this rent must also be repaid to Revenue. Disclaiming an allowance carried forward would also be a cost to the taxpayer where that allowance is no longer available for use.

Rent-a-Room Relief

Where a homeowner lets out a room in their home, gross rental income subject to a maximum of €14,000 can be sheltered by this relief. The home must be occupied by the owner as their sole or main residence during the year in which the letting takes place.

Restrictions in place since Finance Act 2018 sought to reduce the number of properties that were used for bed-and-breakfast type short-term lettings as opposed to longer-term private lettings.

Today, the general rule is that rent-a-room relief will apply only to income for letting periods in the year that are greater than 28 consecutive days. Income from the letting of the room for periods of less than this do not qualify for relief.

No deductions are allowed in calculating the €14,000 limit mentioned above, and no marginal relief applies.

Rent-a-room relief applies where the qualifying conditions are satisfied. Where a taxpayer does not want the relief to apply (e.g. where gross rent is €12,000 but a Case V loss of €2,000 would have arisen were the relief not to apply), an election must be made by the landlord in the income tax return for the period in which the qualifying letting takes place. This election applies to the year it relates to only.

Use of this relief does not affect a person's entitlement to CGT exemption on disposal of the individual's principal private residence.

Non-resident Landlords of Irish Property

A non-resident landlord (NRL) is subject to income tax on its Irish rental profits at the standard rate only (currently 20%). The assessable Case V income of an NRL is broadly calculated in the same way as it is for an Irish landlord.

Rental payments by a tenant to an NRL are subject to withholding tax at the standard rate of income tax. This equates to a prepayment of income tax due by the NRL, and the tax withheld can be deducted by the NRL in calculating its Irish tax liability. Where the withholding tax deducted exceeds the NRL's tax liability, the NRL can claim a refund equal to the excess as part of filing its Irish tax return.

The above withholding tax does not apply where an NRL appoints an Irish-tax-resident agent to act on its behalf in the collection of rent (e.g. an estate agent). The collection agent is then the assessable person for tax, with the amount of tax charged being that which would have applied if the NRL was assessed in its own right.

Mortgagees in Possession

Section 96(3) TCA 1997 provides that tax due in respect of rental profits from property in receivership, or property where the mortgagee has taken possession is chargeable on the mortgagee (e.g. a bank).

The tax liability of the mortgagee is calculated as if it had stepped into the shoes of the borrower and become entitled to the rental profits of the borrower calculated after the deduction of the rental expenses, capital allowances and any Case V losses carried forward that the borrower would have been entitled to deduct.

In a recent Tax Appeals Commission determination, 22TACD2020, the Appeal Commissioner held that the mortgagee (a bank) was not entitled to use current-year trading losses from its banking business to offset the tax liability arising to it as a result of s96(3). It was held that s96(3) was a collection mechanism for tax due by the borrower and that such final liability could not be reduced by the bank's own trading losses.

Conclusion

Understanding the order of the steps in calculating Case V income and the rules applicable to each step is crucial to ensuring that tax due is calculated correctly and costly mistakes are avoided. Value remains available to landlords who seek tax advice before entering into taxable lettings to ensure that interest relief on borrowings is obtained and qualifying expenditure for capital allowance purposes is identified. Good tax advice throughout the period of ownership can also ensure that many of the pitfalls referred to above are avoided (e.g. relying on rent-a-room relief where conditions not satisfied).

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