7.4 Withdrawing capital from the business – relief for loans to fund personal expenses?

Can the landlord obtain tax relief for borrowings secured against the property portfolio if he uses the funds for his own personal use? For example, suppose the landlord wishes to buy his own home or a yacht for his own personal use. His bank agrees to lend him the money which is secured by mortgaging one of his rental properties. Will he be able to deduct the interest payments on the loan against his rental profits?

At first glance, the answer for individual landlords should be ‘no’. The loan has been taken out for purely personal use and therefore the interest payments have not been incurred wholly and exclusively for the purpose of the property business. However, since 2004, HMRC have accepted that the payments are deductible, provided that the landlord has not overdrawn his capital account as a result of using the additional borrowings in this way.

The reason for allowing the interest payments is that the landlord is effectively withdrawing capital from the business and the purpose of the loan is to replace the money that has been taken out. HMRC explain this as follows at BIM 45700:

‘A proprietor of a business may withdraw the profits of the business and the capital they have introduced to the business, even though substitute funding then has to be provided by interest bearing loans. The interest payable on the loans is an allowable deduction. This is on the basis that the purpose of the additional borrowing is to provide working capital for the business. There will, though, be an interest restriction if the proprietor’s capital account becomes overdrawn, see BIM 45705 onwards.’

It is helpful to imagine in this context that the landlord and the business are two distinct entities, even though legally they are one and the same. The landlord has sunk capital into the business – the business owes him that money. If the landlord wishes to take out his money to finance a holiday or to go on a spending spree, he is free to do so – after all, it is his money. But the business may not have sufficient cash in hand, or may need the funds in order to carry on running the portfolio. The business therefore borrows the money in order to replace the funds that have been used to pay back the landlord.

It is for this reason that the landlord’s capital account must be kept in the black. If the account is overdrawn, the business is paying back more than the amount it owes to the landlord. The surplus is not a replacement for working capital but is effectively an interest-free loan to the landlord to finance his own personal expenses.

In short, there is a distinction between the following:

•The landlord takes out a loan to finance his personal lifestyle – clearly not a business purpose, so the interest payments are not allowable.

•The business takes out a loan to pay back the owner and to fund working capital – this is clearly allowable. It doesn’t matter what the owner does with the money once he is paid off.

For corporate landlords, the legal distinction between business and owner is real. However, the same issues do not arise as for individual landlords. If the company borrows to pay back the owners, the deductibility of interest payments is governed by the rules on loan relationships (see **7.5**). There is no ‘wholly and exclusively’ test, but interest payments may still be disqualified on the basis that they have been incurred for an unallowable purpose. An unallowable purpose includes the case where the loan is taken out for a purpose that does not fall within the business or commercial purposes of the company (see **7.5.6**).

Example 1 – buying a Bentley (1)

Dr Mopp is a prosperous village doctor who has amassed a small fortune over the years. He invests primarily in stocks and shares, but he also owns a buy-to-let property in Cant Street. This property was originally acquired for 500,000 with a mortgage of £400,000.

Dr Mopp has an eye for the finer things in life, with a particular interest in vintage cars. His current interest is a vintage Bentley which he has recently spotted in Crockett's Garage. He would like to buy the car, but does not have sufficient funds at the moment, having just returned from a round-the-world trip.

Dr Mopp could sell some of his shares, but feels that this is not a good time to do so. The alternative is to raise funds on the security of the Cant Street property. After a lengthy discussion with his bank manager, the property is revalued at £700,000 and the bank agrees to lend Dr Mopp an additional £100,000. The following day, Dr Mopp goes round to Crockett's and spends the entire amount on buying the Bentley.

Balance sheet before taking out additional borrowings

	£		£
Mortgage	400,000	Property (original cost)	500,000
Capital account	100,000		
	500,000		500,000

Balance sheet after re-mortgaging the Cant Street property

	£	£		£
Mortgage		500,000	Property (original cost)	500,000
Capital account b/fwd	100,000			
Less drawings	(100,000)			
		0		
		500,000		500,000

As a result of withdrawing the entire £100,000, the capital account stands at zero – Dr Mopp has been repaid in full. Because the loan was used to pay off the business owner, the interest payments on the additional borrowings should be allowable against his rental profits.

Example 2 – buying a Bentley (2)

The facts are the same as in Example 1, except that this time the bank has agreed to lend £150,000 instead. Dr Mopp takes out the £100,000 to buy the Bentley, with the remaining £50,000 being used to pay for refurbishing the let property.

Balance sheet after re-mortgaging the Cant Street property

	£	£		£
Mortgage		500,000	Property (original cost)	500,000
			Cash	50,000
Capital account b/fwd	100,000			
Less drawings	(100,000)			
		0		
		550,000		500,000

As in Example 1, the capital account stands at zero. Interest payments on the entire £150,000 are allowable as £100,000 has been used to repay the business owner, and the other £50,000 is used to pay for business expenses incurred in the work on the property.

Example 3 – buying a Bentley (3) – overdrawn capital account

The facts are the same as in Example 2, except that this time Dr Mopp spends the entire £150,000, with the additional £50,000 being used to buy jewellery for his wife's birthday.

Balance sheet after re-mortgaging the Cant Street property

	£	**£**		**£**
Mortgage		550,000	Property (original cost)	500,000
Capital account b/fwd	100,000			
Less drawings	(150,000)			
		(50,000)		
		500,000		500,000

Unlike the previous examples, the capital account is overdrawn as Dr Mopp has taken out too much. The business has more than overpaid him – the additional amount cannot be said to be for business purposes because the business does not owe him that much money. Interest payments are only allowable on the £100,000 required to pay back the owner, with no relief for interest on the additional £50,000.

Unfortunately the waters have been muddied in recent years following a 'change' to HMRC guidance. It is not clear whether this is a real change or whether the confusion has arisen out of poor communication on the part of HMRC. The change appears in the gov.uk guidance *Examples of how to work out Income Tax when you rent out a property*, which states that:

'If you increase your mortgage loan on your buy-to-let property you may be able to treat interest on the additional loan as a revenue expense, as long as the additional loan is wholly and exclusively for the purposes of the letting business.

Interest on any additional borrowing above the capital value of the property when it was brought into your letting business isn't tax deductible.'

On its own, this passage could lead one to conclude that a business owner cannot re-mortgage a property and use the funds for his or her own private use. Indeed, HMRC have rejected a claim on this basis, even though the taxpayer was following the gov.uk guidance as it then was (see 'Room 101' Sam Hart in *Taxation* magazine, 19 October 2017). So is it no longer the case that a landlord can set off such interest costs against rental income?

The answer is not entirely clear from the point of dealing with HMRC.

It should be noted that the gov.uk guidance is a 'quick guide' and does not address the specific issue of the business owner withdrawing his or her own capital. Past guidance did in fact contain an example dealing with this issue, but this has been deleted.

By contrast, the more comprehensive guidance at BIM 45700 is still in place. This guidance makes it clear that the business owner is permitted to withdraw his capital and to claim interest relief on substitute funding. To add further confusion, HMRC have stated that there is no change in policy or interpretation with respect to the changes to the gov.uk guidance (see the Taxation article referred to above).

Going back to basics, the key must lie in the words of the legislation. Under ITTOIA 2005, s. 34, the expense must be incurred 'wholly and exclusively' for the purpose of the business. Is this the case where the landlord is withdrawing his or her capital and where substitute funding is raised to carry on running the business? The answer lies in the question – surely it must be a 'yes'. However, given the current level of uncertainty regarding HMRC's position, landlords should be prepared to fight their corner on this issue.

Law: ITTOIA 2005, s. 34, 272, 272ZA

Guidance: BIM 45700; tinyurl.com/2vzam83u (HMRC: *Work out your rental income when you let property*); tinyurl.com/2vzam83u (HMRC: *Examples of how to work out Income Tax when you rent out a property*)