

## Limited Interests – Some Taxation Implications

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### Introduction

Chattels are things that can be owned; land is not a chattel and cannot technically be owned. Technically, a person owns an “estate in land” or an “interest in land”. An estate or interest in land is some package of rights over land and various responsibilities accompanying those rights. These rights, by definition, fall short of absolute ownership, but can be quite extensive.

A freehold interest is an exclusive right to enjoy the possession and use of a parcel of land or other asset for an indefinite period. In contrast, a leasehold interest is for a fixed, definite period. See also fee simple absolute in possession.

We often speak of buying or selling land (or a house for example). Typically when a person buys a house they are acquiring a freehold interest. All students of P2 tax should be aware of the tax consequences of not only disposing of a freehold interest but also a lesser interest for example a leasehold interest.

### CGT

CGT will only arise when a premium is paid on disposal. A premium is a sum payable in connection with the granting of a lease, the surrender of a lease or the assignment of a lease. The creation of a long term lease (50 years or more), by a person who holds the freehold, which is subject to a premium, will constitute a part disposal. The normal part disposal rules will apply.

Proceeds		Premium
Less		Disposal Costs
Less	$\frac{\text{Cost of freehold} \times \text{Premium}}{\text{Premium} \times \text{Value of Part remaining}}$	Cost of Lease
		<hr/> GAIN

Where the lease is less than 50 years part of the premium is charged to Income tax under Case V. The part charged to Case V is subject to a formula. For example a 21 year lease would be chargeable to tax as follows:

Proceeds		Premium
Less	$\text{Premium} \times \frac{(21-1)}{50}$	Disposal Costs
Less	$\frac{\text{Cost of freehold} \times \text{Premium}}{\text{Premium} \times \text{Value of Part remaining}}$	Cost of Lease
		<hr/> GAIN

### VAT

Letting in the context of the new VAT on Property rules includes leasing and letting. Letting or leasing of property is exempt from VAT but the landlord may, with some exceptions, exercise an option to apply VAT to a letting. No distinction is made

between leases for a period of ten years or more and short-term lettings, as was the case before 1 July 2008. However, certain very long leases are treated as a supply of the property: These are referred to as freehold equivalent. A landlord who makes an exempt letting is not entitled to deduct VAT incurred on the acquisition or development of a property, which is subject to the letting.

A landlord may opt to tax a letting. However there are restrictions as to the circumstances where a landlord may avail of the option.

Where a landlord opts to tax a letting, the letting is subject to VAT at the standard rate. The landlord is entitled to deduct VAT incurred on the acquisition or development of a property that is to be used for the purposes of making taxable lettings.

The option to tax applies to an individual letting of a property. Under the old waiver of exemption rules, a waiver applied to all short-term lettings (period less than 10 years) of the landlord. That is not the case with the option to tax. Indeed, it may well be that a landlord may opt to tax a letting of part of a building while making an exempt letting of the rest of the building.

A landlord who claims a deduction for input tax incurred on the acquisition or development of a property, which is to be used for letting, is regarded as having opted to tax the lettings of that property. When the property is let, the landlord must either agree in writing with the tenant that the letting will be taxable or issue a document to the tenant stating that the letting will be taxable. Otherwise, the option to tax that the landlord was considered to have made by claiming input credit will be regarded as terminated and the landlord will be subject to a Capital Goods Scheme adjustment on termination of the option.

A premium is treated as part of the consideration for the supply of the property. The VAT treatment of such a premium will follow the general rules for VAT on supplies of property. Where a premium payable by tenant to landlord as consideration for landlord agreeing to grant the lease, the VAT treatment of the payment will depend on whether the landlord has opted to tax the letting in question. Where the landlord has opted to tax the letting, the premium is taxable; where the landlord has not opted to tax the letting, the premium is exempt.

## **CAT**

Where less than the full interest (i.e a freehold) is granted by way of gift or inheritance, a limited interest is taken. A limited interest may, for example, be a life interest, a right of residence or an interest for a limited period (say 10 years).

Where a benefit is a limited interest, its taxable value will obviously be less than if the freehold had been transferred. Consequently, the beneficiary will not be taxed on the full market value of the property. The value of the property for tax purposes in such cases will depend on a number of things including the age and gender of the beneficiary and the number of years for which the benefit is taken.

Actuarial factors (covering age, gender and the number of years for which a benefit is taken) are used in determining the taxable value of a limited interest.

A woman inherits a house (market value €650,000) subject to a life interest under a will. Under the terms of the will the inheritance is subject to a life interest conferred on a man aged 65.

Value of benefit to man =  $650,000 \times 0.5007^1 = 325,455$

If that benefit is taken by the man for a period of 5 years the value of the benefit is the higher of the value of the life interest or fixed period:

Value of benefit to man =  $650,000 \times 0.5007$  or  $650,000 \times 0.2869^2 = 324,545$

Entitlement to a right (e.g. a right of residence) constitutes a benefit. This benefit must be capitalised in order to ascertain the market value to be included in your return.

What is the difference between a right of residence in property and having a life interest in property? A right of residence is a right to live in property only. This right is usually a charge on property. A life interest in property means that the person with the life interest effectively owns the property for his or her life. An exclusive right to reside in a dwelling-house, is equivalent to having a life interest.

The formula should be used to calculate the market value of a benefit charged on property e.g. a right of residence, is as follows:

$(\text{Annual Value of Right} / \text{Annual Value of Property}) \times \text{Market Value of Property upon which the right is charged.}$

A woman inherits a house (market value €650,000) subject to a life interest under a will. Under the terms of the will the inheritance is subject to a right of residence conferred on a man aged 65.

Annual value of right of residence is €1,500

Annual value (market value of annual rent) of the house is €15,000

Taxable value of benefit taken by man:

$(€1,500 / €15,000) \times €650,000 \times 0.5007 = €32,545$

Value taken by woman

$€650,000 - €32,545^3$

A charge to tax arises where a person has the use and enjoyment of property either for no consideration or for less than full consideration. If, the "free" use is on-going, the benefit is deemed to be taken on 31 December each year. The following examples explain how the benefit is calculated.

### Example 1

X gives the free use (rent free) of a house valued at €350,000 to his friend Y. The annual market rent is €12,000. Y is deemed to take a gift of €12,000 on 31 December each year that he has the use of the house and each deemed gift is taken into account for aggregation purposes.

### Example 2

X gives the use of a house valued at €350,000 to her friend Y. The annual market rent is €12,000. Y pays X €7,000 per annum. Y is deemed to take a gift of €5,000 ( $€12,000 - €7,000$ ) on 31 December each year that he has the use of the house and each deemed gift is taken into account for aggregation purposes.

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<sup>1</sup> Actuarial value man aged 65

<sup>2</sup> Actuarial value for defined period 5 years

<sup>3</sup> Market value of the benefit i.e.  $(€1,500 / €15,000) \times €650,000$  and not the taxable value of the benefit is deductible.