Furnished Holiday Lettings – or Businesses?

The government announced earlier this year, without any consultation, that the long-established rules for Furnished Holiday Lettings (FHLs) are to be scrapped from 6th April 2010 – now just four months away.

The FHL rules were beneficial because they treated certain holiday lettings operations as if they were a "trade" rather than a property business, which gave certain tax advantages, primarily:

> *Under the FHL rules, landlords are treated as though their qualifying FHL business is a trade for the following purposes:*
>
> - *loss relief;*
> - *capital allowances;*
> - *Landlords Energy Saving Allowance (LESA);*
> - *certain capital gains reliefs (including business asset roll-over relief, entrepreneurs' relief, relief for gifts of business assets, relief for loans to traders and exemptions for disposals of shares by companies with a substantial shareholding); and*
> - *relevant earnings when calculating the maximum relief due for an individual's pension contributions.*
>
> ***HMRC, "Furnished Holiday Lettings" Technical Note 2009***

These were never available for all holiday lettings, but only those who met a set of fairly arbitrary criteria:

> - *The business must be carried on commercially, and with a view to a profit;*
> - *Availability: the property must be available for commercial letting as holiday accommodation to the public for at least 140 days during the relevant 12 month period;*
> - *Letting: the property must be commercially let as holiday accommodation to members of the public for at least 70 days during the relevant 12 month period. A letting for a period of longer term occupation is not a letting as holiday accommodation for the purposes of the letting condition; and*
> - *Pattern of occupation: not more than 155 days must fall during periods of longer term occupation.*
>
> ***HMRC, "Furnished Holiday Lettings" Technical Note 2009***

So why are the FHL rules being scrapped now?

On the face of it this is another example of the European Union non-discrimination rules causing problems for the UK tax system, because the old FHL rules only applied to holiday property in the UK, not in the rest of the EU. That discriminated against cross-border EU investment, by giving UK properties a tax advantage that was not enjoyed by properties in the rest of the EU, so the government therefore had to either extend them to cover holiday property across most of Europe or scrap them altogether.

Extension might have been useful for the many British people with holiday property in France or Spain, which are rented out when they are not in use by family or friends.

Sadly they instead took the second option of abolishing the rules for everyone.

The government's decision was to scrap the FHL rules from next year, but in the meantime to extend them to the whole of the European Economic Area (that's the EU plus Iceland, Liechtenstein and Norway, who also benefit from the EU non-discrimination laws).

As the Revenue's note explains:

> *Landlords with income from furnished holiday accommodation in the UK are currently treated as if they are trading for certain tax purposes, as long as they satisfy certain tests, under the Furnished Holiday Lettings (FHL) rules.*
>
> *Landlords with income from furnished holiday accommodation elsewhere in the European Economic Area (EEA) cannot currently qualify for this treatment. They were treated instead in the same way as landlords of other types of overseas property, under the property income rules.*
>
> *This difference may not be compliant with European law. The Government has decided it should repeal the FHL rules from 2010-11. Until the FHL rules are repealed, HMRC will regard the FHL rules as applying to furnished holiday accommodation elsewhere in the EEA.*
>
> ***HMRC, "Furnished Holiday Lettings" Technical Note 2009***

In fact scrapping the FHL benefits was probably the government's preferred option even if the EU issue had not brought it to the fore – the last few years have not exactly been marked by a helpful attitude to rural businesses.

Note that if you do have qualifying holiday property in the EEA, it is still possible to amend your 2008/9 tax return to take advantage of the now-available FHL rules (if they are beneficial), but this needs to be done by the usual deadline of 31st January 2010.

So what do the new rules mean to those who have, or are thinking of acquiring, holiday properties? *Tax Confidential* asked its rural tax expert, Julie Butler, to explain.

Lack of consultation

There is no doubt that there has been some serious debate and lobbying by major holiday cottage groups and tourism groups to overturn the 22nd April 2009 decision.

It has been promoted that there was no advance discussion before 22 April 2009.

However, the Government via Stephen Timms, the Financial Secretary, have promoted that this will be discussed at the time of the forthcoming pre Budget Report before the introduction of the measure in Finance Bill 2010.

Fairness for Residential Landlords

One point raised by Stephen Timms is fairness to the residential landlord. It appears he considers that many residential landlords provide services and undertake activities similar to the FHL landlords. Perhaps that is a whole separate subject for debate – it provides to lead and give direction to the thinking that must arise from the proposed changes.

FHL Tax Relief restricted to Income Tax and Capital Gains Tax

There must also be the consideration of the fact that the FHL rules only ever gave advantages in respect of income tax and Capital Gains Tax (CGT) relief - Inheritance Tax relief via Business Property Relief (BPR) was, and is, a separate subject, and should be unaffected by this announcement.

So what tax reliefs will apparently be lost from 6 April 2010?

1. The sale of the FHL business will no longer be eligible for the following capital gains tax reliefs:
   (a) entrepreneur's relief (which reduces the taxable gains on the sale of a business to an effective 10% rate from an 18% rate);
   (b) roll-over relief (which allows gains arising on the sale of business assets to be deferred if the proceeds of sale are reinvested into other business assets); and
   (c) specific hold-over relief for business assets (which allows the accrued gains arising on a lifetime gift of property to another individual to be deferred and assumed by the donee).
2. Losses from FHLs will not be able to be set against other income (e.g. other trading or employment income).
3. Capital Allowances will no longer be available (instead there will be a 'wear and tear' allowance).
4. Income from FHLs will no longer be 'relevant earnings' for pension purposes (which could affect those who have no other trading or employment income).

The Way Forward for the Holiday Business

With the FHL provisions abolished, the trading advantages set out above will not be available for a mere landlord – but it will still be possible to claim them by qualifying as a "trade" under the normal tax rules for all businesses. The new approach therefore has to be "forget landlord, think business" and think on the concept of a hotel and the provision of services.

Even under the old rules, to qualify as FHLs the operations had to be commercial. But now that has to be taken further.

From the practical commercial viewpoint the owner of the accommodation has to decide what direction they want to take their holiday business – landlord or viable, economic commercial undertaking (trade)? Perhaps in some situations the advantages of the old FHL rules were not really valuable, and so a normal landlord tax treatment may not be too much of a disadvantage. But in many cases the loss of the FHL treatment will be a significant disadvantage.

If you are opting for trading treatment, the new thinking for genuine cottage businesses is to forget the concept of landlord and letting and instead consider the new A and B of holiday rental:

"A" – Adventure in the nature of trade

"B" – Business

So what are the problems of the "A" word – the adventure in the nature of a trade?

1. A true commercial business is "as it says on the tin" an adventure - an undertaking that involves risks and service to the client.
2. Don't forget about Class 4 National insurance Contributions (NIC). As a business when the profits exceed a certain level then Class 4 NIC is due, although there may be deferments for those with Class 1 earnings through employment and retirement age advantages.

Income Tax

The loss of capital allowances and the move to wear and tear or the renewals basis (under normal rules for lettings) must be considered and risk/cost assessed. Depending on the level of relevant expenditure, the effect may be small.

The largest disadvantage of the abolition of the FHL rule has to be the loss (excuse pun) of the ability to offset the income tax losses against total income. In order to mitigate this disadvantage the cottage owner must either make a robust move toward the genuine trade, in order to continue claiming loss relief, or alternatively look at the reasons for the loss in order to eliminate losses, for example examining closely loan interest, non-commercial transactions, areas of excessive expenditure.

An action plan could be:

1. Loans – could these be repaid from other investments? Alternatively, for those where holiday lettings are part of a larger operation, consider a total restructure. For example, for those with 'on the farm' lettings, loans taken out to fund the purchase of new machinery for the farm should be deductible, which would free up spare cash to pay off the holiday lettings loans which no longer generate loss relief.
2. Expenditure – look at timing, and consider incurring maximum FHL expenditure prior to 5 April 2010 while capital allowances are still available.

3. Commerciality – the "C" word. Review all non-commercial arrangements, look at any method of improving the commercial approach and evidence all attempts at the business direction.

It is considered that possibly some FHL loss claims have been allowed which should have come under closer HMRC scrutiny. Perhaps those in this position should not "protest and shout" too much!

VAT

The FHL rules did not apply to VAT so in theory the cottage owner is stuck with the problem regardless of 6 April 2010. But a change is being lobbied, so that there should be no VAT charged if the income is letting property. The word "consistency" comes to mind.

There are therefore strong arguments to maximise the input VAT claim prior to 5 April 2010. However, some FHL property might convert back to normal residential lets and VAT planning around this action must be considered.

Tax Planning – Which tax is the driver?

If it is accepted the FHL rule book is thrown away from 6 April 2010 and the birth of the Furnished Holiday Business (FHB) takes place the owners of the property must consider what the main drivers are for wanting FHL tax relief and the tax reliefs that surround a business providing holiday accommodation and use this to help their decision making accordingly.

Inheritance Tax

Elderly owners of holiday cottages could well be very driven by the possible Inheritance Tax reliefs, particularly Business Property Relief (BPR), but in fact Inheritance Tax reliefs were never part of the FHL package. The Inheritance Tax position should therefore be unaffected by this reform – although the Revenue seem to be also launching a separate assault on the Inheritance Tax reliefs for holiday rentals (see below).

Availability of Inheritance Tax relief

Inheritance Tax relief is normally allowed on holiday rental properties where the following is in place:

- The lettings are short term (for example, weekly, fortnightly); and
- The owner – either himself or through an agent such as a relative or housekeeper – was substantially involved with the holidaymaker(s) in terms of their activities on and from the premises

If those conditions are met, Inheritance Tax relief should be available even if the letting were for part of the year only.

Investment business?

As usual, whether the Inheritance Tax test will be satisfied will depend on the facts. The question is whether the businesses would be excluded by the Inheritance Tax Act 1984 (IHTA 1984), s105(3):

> *(3) A business or interest in a business, or shares in or securities of a company, are not relevant business property if the business or, as the case may be, the business carried on by the company consists wholly or mainly of one or more of the following, that is to say, dealing in securities, stocks or shares, land or buildings or making or holding investments.*
>
> ***Inheritance Tax Act 1984 s105(3)***

In order to be an active business rather than "making or holding investments", the criterion is whether the owner (either himself or through agents), "was substantially involved with the holidaymaker(s) in terms of their activities on and from the premises." The key issue in order for cottage owners to secure maximum tax reliefs is therefore to be involved in the actual services provided.

Inheritance Tax relief will depend on "level and type of services" provided to holidaymakers, e.g. provision of meals, cleaning and hotel type services.

'On a farm' holiday lettings may be eligible under *Farmer v IRC* principles and now the *Earl of Balfour* as part of a larger business (this was discussed in the August (Balfour and Inheritance Tax) and September (Small Landed Estates) issues). Beware a separate "person", e.g. farmer's wife is carrying on business for VAT reasons, i.e. to not charge VAT on the holiday service.

Case law suggests that in order to qualify for BPR, it might be necessary to own a number of properties.

Risk areas which might jeopardise the claim for relief from Inheritance Tax are:

- Where no services are provided to holidaymakers;
- Where lettings are to friends and relatives; and
- Longer-term lettings (including assured shortholds).

The Revenue get tougher

Unfortunately it appears that HMRC are tightening up on what was a long-established position, and are scrutinising claims for BPR on holiday lettings. Let us look at the Inheritance Tax Manual:

> *In the past we have thought that business property relief would normally be available where:*
>
> - *The lettings were short term, and*
> - *The owner, either himself or through an agent such as a relative, was substantially involved with the holidaymakers in terms of their activities on and from the premises.*
>
> *Recent advice from Solicitor's Office has caused us to reconsider our approach and it may well be that some cases that might have previously qualified should not have done so. In particular we will be looking more closely at the level and type of services, rather than who provided them.*
>
> *Until further notice any case involv-*

ing a claim for business property relief on a holiday let should be referred to the Technical Team (Litigation) for consideration at an early stage.

IHTM25278 – Caravan sites and furnished lettings: Holiday Lettings

It is considered by many that the availability of BPR relief from Inheritance Tax for furnished holiday rentals is a tax case that HMRC are waiting to be heard by the Tax Tribunal.

HMRC would no doubt like to choose a hopeless BPR claim that can be "walked all over" and destroy the idea of furnished holidays qualifying for BPR as a "non-investment business". It is therefore essential that the furnished holiday case that goes before the Revenue Tribunal must be strong.

HMRC would like to see the furnished holiday sector put firmly in the claws of s.105(3), but this insults the real holiday cottage businesses that exist in the UK. If any BPR case looks like appearing before the Revenue Tribunal the UK tourist authorities must put all their energy into fighting the case.

Passing on the business

Is this a good time to pass the holiday accommodation to the next generation?

If it is considered that an "adventure in the nature of trade" and "business" can be established for an elderly taxpayer is there an opportunity to pass the property to the next generation now?

Passing on - Capital Gains Tax (CGT)

The apparent CGT negatives of the change from 6 April 2010 have been presented earlier. The end of the FHL rules mean that entrepreneurs' relief, rollover relief and holdover relief will no longer be available, potentially leaving the owner paying 18% capital gains tax on a handover as if they had sold the holiday accommodation at its full market value.

However there is a temporary CGT planning point re the holdover relief, as set out below:

Note that until 5 April 2010, CGT holdover relief will be available under s.165 TCGA 1992 if the FHL "trading conditions" (availability for letting and actual short lettings for holidays) are satisfied (s.241 TCGA 1992). This usually avoids all CGT when the property is given to the younger generation, with the accrued gains being deferred and transferred to the recipients, and only taxed when the recipients themselves dispose of the property.

This therefore presents a planning opportunity if the transfer takes place before 5 April 2010.

However, it is likely that these CGT advantages, especially rollover, i.e. being able to roll the gain into another property, will be lost after that date.

Those most adversely affected by the CGT changes will be owners of properties with development potential or large potential gains that they plan to realise in the near future. The choices would have to be ensure a robust business classification (to continue to claim the reliefs under the normal business rules) or consider action before 5 April 2010 when the CGT reliefs are still available.

Passing on – Inheritance Tax

With HMRC announcing their intention to "look more closely" at claims for BPR relief for holiday accommodation, many will be wary about passing on a furnished holiday operation because of fear of an inheritance tax charge. However a gift to the next generation can still avoid inheritance tax through the normal Potentially Exempt Transfer (PET) rules, provided the donor survives for seven years from the date of the gift. This will avoid any arguments about whether BPR is available.

Loans

FHL/FHB and loan planning should be considered in the round. Interest is allowed for income tax rules based on the PURPOSE of the loan whereas for Inheritance Tax purposes the loan should be allocated against the property it is secured on. Loans secured on non-business property are efficient and need real contemplation in the restructuring moving forward.

This is of particular interest for those whose furnished holiday lettings are only a part of the overall business operation. Ideally loans should be taken out for a business purpose (for example to buy farm machinery) to maximise the relief for income tax, but should be secured on property that would otherwise be subject to Inheritance Tax (i.e. on non-business property where BPR would not be available).

Summary

Forget the "L" word ("lettings"), think the "B" word ("business") - there are a large amount of "FHBs" in the UK which need to be recognised as a business now. Rethink, restructure and register the business with HMRC/Contributions Agency as a trade using form CWF1 (check HMRC website) when and if the total rethink and restructure is carefully in place.

For the property that will stay as a "FHL" and move into the normal rental rules, there is a lot of planning to be undertaken by 5 April 2010. ☐

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