Tax efficient UK holiday lets

by Julie Butler

After such a wet August a review of the tax efficiency of UK property let to holidaymakers might seem a joke article, but think of all those campers looking for a warm bathroom and central heating ...

Capturing the letting income as Schedule D

Income from furnished lets is taxable under Sch. A, unless the landlord is in occupation and provides services beyond those usually provided by a landlord, in which case Sch. D, Case I may apply. Furnished holiday lets, however, can be treated as a trade if certain conditions are met to achieve beneficial loss relief, business asset taper relief (BATR), capital allowances, and other allowances that cannot be achieved under Sch. A. To benefit, the property must be available for commercial letting as holiday accommodation for at least 140 days a year and actually let for at least 70. It must not be in the same occupation for a continuous period of more than 31 days for at least seven months in any 12-month period (*Income and Corporation Taxes Act* 1988 (ICTA 1988), s. 504(3)). If these conditions are met, the letting of furnished holiday lets (FHLs) is treated as a trade for tax purposes.

Wear and tear v capital allowances

Wear and tear allowances cannot be claimed in respect of holiday lets where capital allowances are available. If a house is let long-term, however, expenditure on furniture and fixtures qualifies for wear and tear allowances. Wear and tear is calculated on 10% of the rents less any expense that the landlord meets that would normally be paid by a tenant, such as council tax (extra statutory concession B47 para. 2).

The wear and tear allowance is meant to cover furniture and fixtures that, in unfurnished lodgings, a tenant would provide (e.g. cookers, washing machines, etc.) It only applies to residential property that is furnished in such a way that the tenant does not have to provide any furnishings.

Instead of wear and tear, the cost of renewing furnishings can be claimed. There is no deduction for the original expenditure and no claim can be made for the cost of any improvement in a new asset when the old asset is discarded. The landlord can also claim the cost of renewing fixtures that are not usually removed if a property is vacated or sold (e.g. baths, toilets, etc.).

Location, location, location

The holiday let does not have to be in a traditional holiday location. It can be in a city, near a racecourse etc., as long as it is in the UK and meets the furnished holiday let criteria above (ICTA 1988, s. 503–504).

The VAT trap

The standard rate of VAT applies to rents for holiday lets as long as they are advertised as such (*Value Added Tax Act* 1994 (VATA 1994), Sch. 9 grp. 1, note 13). If they are offered at lower rates in the off-season, they can be treated as residential accommodation if they are let for that purpose for more than four weeks and the property is clearly situated in a resort where trade is clearly seasonal. Thus a VAT-registered sole trader owning a holiday cottage will have to charge output VAT on their VAT return, but will be able to claim input VAT on repairs and related costs. If high expenditure on the holiday let is planned, then the organisation of the ownership of the property to come within the scope of VAT can be considered as a tax planning exercise.

Two or three FHL properties would clearly cause turnover to rise above the VAT registration limit.

Protecting the income

During the winter months it might be difficult to attract holidaymakers to traditional tourist locations and short-term lets for less than five months can be considered as income efficient without disturbing the FHL status (ICTA 1998, s. 504(3)). However, this could jeopardise the inheritance tax (IHT) position.

Protecting the assets from inheritance tax

It is important that clients who own holiday cottages should try and ensure, as far as possible, that they qualify for IHT relief. With property prices appearing to be permanently on the increase, the need to shelter these assets from IHT is greater than ever and should be planned accordingly.

Case law suggests that in order to qualify for business property relief, it might be necessary to own a number of properties. However, it will also be necessary to be involved in running the properties. The Capital Taxes Office (CTO) *Advanced Instruction Manual* (at para. L.99.3) states:

> 'The Inland Revenue Solicitor has advised the office that in some instances the distinction between a business of furnished holiday lettings and, say, a business running a hotel or a motel may be so minimal that the Courts would not regard such a business as one 'wholly or mainly holding investments' for the purposes of s.105(3):
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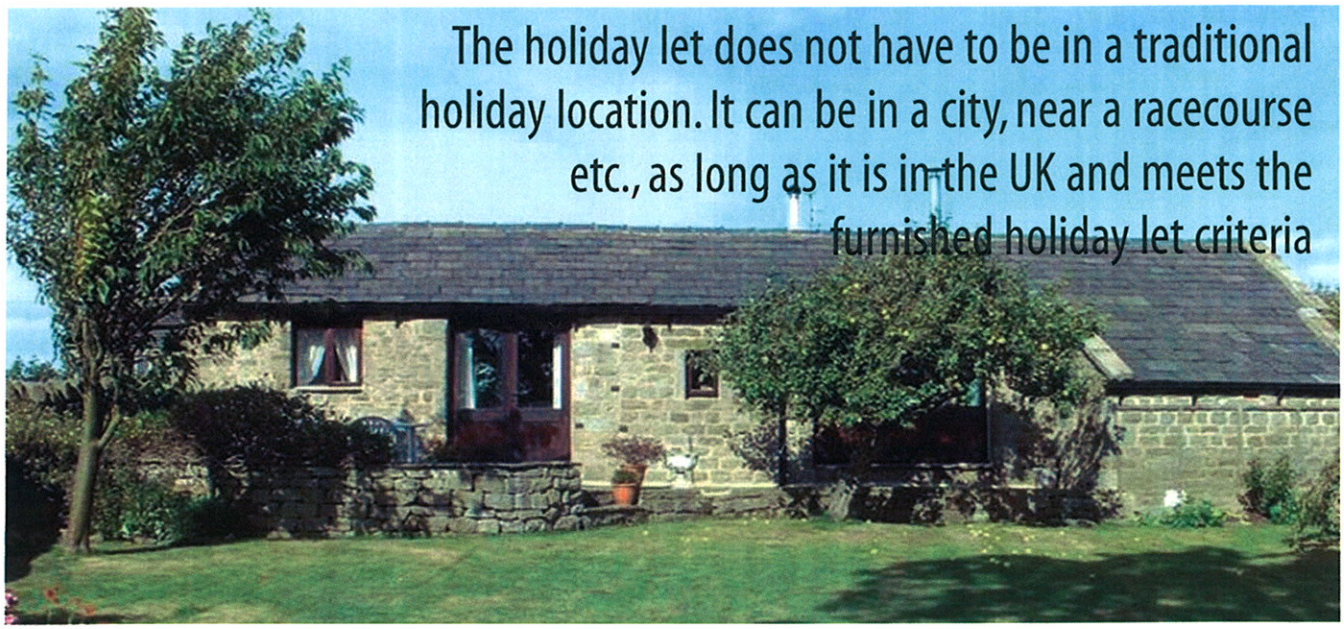
> IHT relief is normally allowed on FHLs where the following is in place:



- FHLs – 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, even if the letting were for part of the year only.'

As usual, whether this IHT test will be satisfied will depend on the facts.

The Inland Revenue's solicitor has advised the CTO that many more such businesses would not be excluded by the *Inheritance Tax Act* 1984 (IHTA 1984), s. 105(3) than the CTO had previously thought. The criterion is where 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 landlords to secure maximum tax reliefs is to be involved in the actual services provided.

Risk areas which might jeopardise the IHT claim are:

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

Maximising the income tax loss relief

Another advantage of FHLs is the ability to claim losses under ICTA 1988, s. 380 and 381, i.e. against total income in the year of the loss and the following year with all the advantages of opening year's losses. However, it is important to look at one tax-planning drawback.

Where a furnished holiday accommodation was first let as furnished accommodation only, there can be a restriction under s. 381, i.e. the holiday accommodation is deemed for s. 381 to start when furnished lettings began, not when lettings as holiday accommodation began.

The 'sideways' loss relief advantage of the FHL makes interesting income tax planning in years of high earnings for the taxpayer and possible high FHL overhead or management expenses.

Rollover of capital gains

The FHL qualifies as an asset that capital gains can be rolled over into. It might be that the FHL conditions are too difficult to comply with and the property is used as a residential let instead. If this is the case, then rolled over gain will not crystallise until the property is sold.

Maximising the DEFRA grants

It is considered that the government wants to promote the UK tourist industry and this is not just through beneficial tax reliefs, but through rural initiative grants promoted by the Department for Environment Food and Rural Affairs (DEFRA).

Contact point: www.defra.gov.uk

Many DEFRA grants require the claimant to be a 'farmer', but generally not for bed and breakfast and FHL applications.

Local land agents can also be of a great help.

Checklist for maximising the FHL benefits:

- Schedule D, Case I status with the provision of services by the landlord.
- Ability to claim 'sideways' loss relief.
- Potential protection from IHT where substantial involvement with holidaymakers.
- Rollover of capital gains into the purchase, possible change of use and capital gains tax (CGT) crystallization only on the disposal.
- VAT 'sting' for registered individuals, but use to advantage when high expenditure?
- Become a 'grant grabber' and maximise grant applications.

Clearly strict conditions have to be complied with to achieve FHL status and all the potential CGT, IHT and loss claim benefit. Check all is carefully in place.

So much of tax planning is helping to make clients aware of beneficial tax reliefs but FHLs are a prime example of where the tax rules have to be met every year and must be 'policed' to ensure ongoing compliance.

Has your practice carried out a FHL compliance check? Have they been met each year?

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