

Taxman's holiday

With the property market facing falling prices and slow sales, it is timely to look at the letting market and the tax advantages of furnished holiday lets, says Julie Butler

In the UK, business can have distinct tax advantages, including business property relief (BPR) for inheritance tax (IHT). Other advantages are entrepreneurs' relief (ER) and rollover relief for capital gains tax (CGT), and the offset of 'business' losses sideways against total income.

Inheritance tax (IHT) – almost a hotel

There has been a recent change by HM Revenue and Customs (HMRC) to its approach to IHT.

It is important that clients who own holiday cottages should try to ensure, as far as possible, that they qualify for IHT relief. Case law suggests that in order to qualify for BPR, it might be necessary to own a number of properties. It will also be necessary to be involved substantially in running the properties. Current emphasis is being placed on the level of services provided – the more services offered, the more likely that BPR will be achieved.

IHT relief has recently been allowed on furnished holiday lets (FHLs) where the following is in place: the lettings were 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 period was for part of the year only.

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

The HMRC solicitor had advised the Capital Taxes Office (CTO) that many more such businesses would not be excluded by the Inheritance Tax Act 1984 (IHTA 1984), section 105(3) than the CTO had previously thought. The criterion is where the owner (either himself or through agents) is '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 relief is to be involved in the actual services provided. It could be that some properties should not have done.

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).

The HMRC approach now is that any claim for BPR on a holiday let should be referred to the technical team (litigation) for consideration at an early stage.

BPR has been achieved on one property, but there is greater emphasis on the need to be involved in the running of the property; to be really involved in the 'business' of FHLs.

The use of an agent is not enough. In an ideal situation, the owner will provide meals and daily cleaning, with services similar to hotel accommodation.

What qualifies as a holiday let?

The property must meet certain requirements to qualify as an FHL and be eligible for the tax reliefs thereon. The property does not have to be in a tourist area, but the pattern of lettings must satisfy these three conditions (Income Tax (Trading and Other Income) Act 2005, part 3, chapter 6):

1. The property must be available for commercial letting as holiday accommodation for at least 140 days a year.
2. The property must actually be let as holiday accommodation for at least 70 days a year.
3. The property must not normally be let for a continuous period of more than 31 days to the same tenant in seven months of the year, and those seven months include any months in which it is actually let as holiday accommodation.

Whereas non 'holiday let' periods can qualify for the income tax, national insurance (NI) and CGT advantages, in order not to fall foul of IHTA 1984 section 105(3), greater evidence of the provision of practical services to genuine holidaymakers will be helpful.

Other relevant factors might be:

- the cottage is located in a tourist area;
- the property is marketed professionally;
- small business rates are paid;
- the cottage is awarded a rating by the English Tourist Board or equivalent;
- public liability insurances are paid on the property; and
- the operation of the business is commercial, and profits are made and tax paid accordingly.

The tax-planning confusion rests with the extent of the involvement with the tourist. The tax relief is helped if there are lots of services provided, such as the 'meet and greet',

organising car hire, cleaning and laundry, supply of basic food for the fridge, and so on. The owner can subcontract out these services. The important point is the extent of the involvement with the holidaymakers, even if this is handled by an agent. The key is to ensure there is a contemporaneous record of the services provided. Further examples are visits to the cottage with local maps and guides to historic attractions, and organising the maintenance of the property before, during and after the period let, including gardening.

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, schedule 9, group 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.

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 subsequently used as a residential let instead. If this is the case, then rolled over gain will not crystallise until the property is sold.

Entrepreneurs' relief

From 6 April 2008, the taxpayer can no longer claim business asset taper relief (BATR) on capital gains, and the flat 18% rate applies to all gains. However, ER is available, which allows the effective 10% rate of tax for £1 million of lifetime gains on business disposals.

Let commercial property does not qualify for ER, which includes farm business tenancies, with the exception of furnished holiday lets which do qualify as an effective 'trade'.

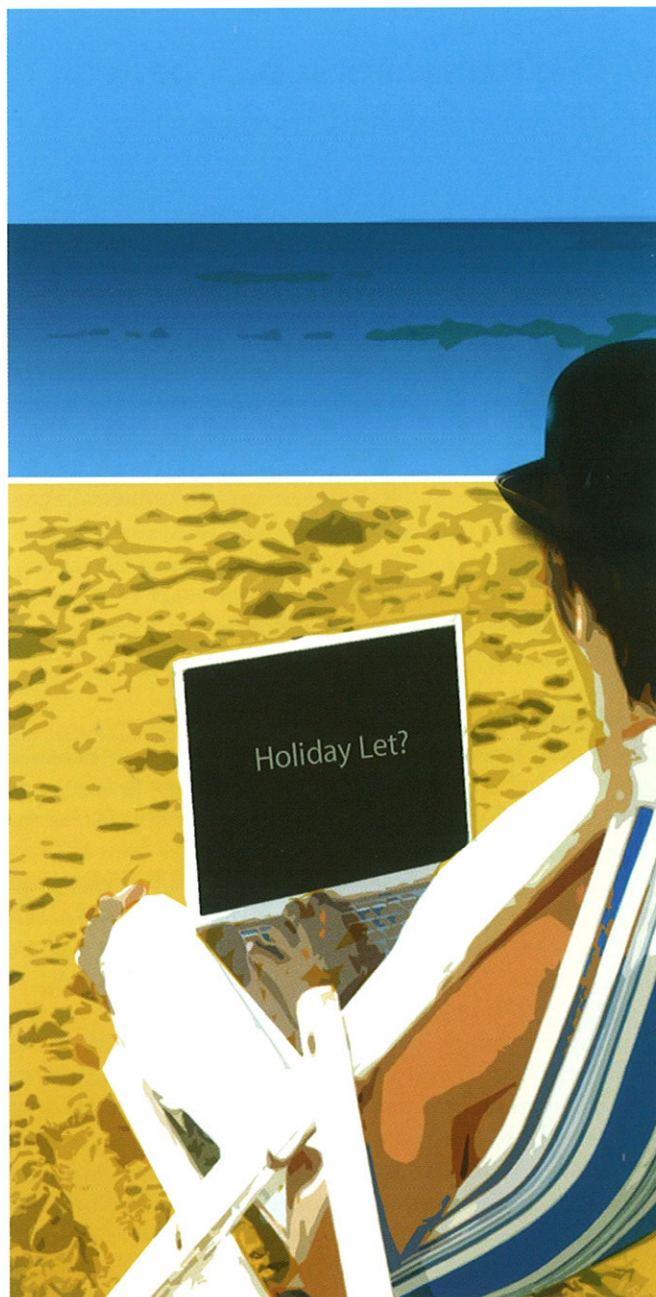
Maximising the income tax loss relief

Another advantage of FHLs is the ability to claim losses against total income in the year of the loss and the following year with all the advantages of opening year's losses. 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.

Summary of the advantages

Checklist for maximising the FHL benefits:

- trading 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 CGT crystallisation only on the disposal;
- VAT 'sting' for registered individuals, but possibly use to advantage when high expenditure; and
- entrepreneurs' relief.

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