



# D H C A C C O U N T I N G

Tax Advisors

Business Development Specialists

## TAXATION OF PROPERTY

### TAX ADVANTAGES FOR FURNISHED HOLIDAY LETTINGS

*Prepared for Hoseasons Group*

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#### **FURNISHED HOLIDAY LETTING AND BUSINESS STATUS**

**Whilst the 2011 budget introduced changes to the tax legislation applying to Furnished Holiday Letting Businesses, those that meet the specified criteria will continue to be treated as businesses for Income Tax purposes and be treated as business property for Capital Taxes purposes, which ensures that they continue to benefit from valuable tax reliefs not available with other types of property letting.**

**The information set out in this leaflet applies to both UK FHL businesses and to those set up in other countries within the European Economic Area.**

*Disclaimer:*

*This is a general guide for information purposes only and specialist advice should always be taken in relation to matters concerning taxation.*

*DHC Accounting cannot accept any responsibility for any loss occasioned to any person no matter howsoever caused or arising as a result of action taken or refrained in consequence of the content of this report.*

## **INTRODUCTION**

The type of expenditure that can be claimed as a deduction from income is broadly similar for FHL and other types of property letting businesses. There are however, profound differences between the two options in respect of their treatment for tax purposes.

These differences mainly stem from the fact that the letting of commercially available furnished holiday accommodation is treated as a business activity for all tax purposes. Because of this, there are considerable tax advantages in letting property as furnished holiday accommodation.

To gain these tax advantages, the holiday letting business must first satisfy certain conditions set out in the Income Tax (Trading and Other Income) Act 2005 (Sections 323 to 326). Broadly speaking:-

- The property must be available for letting as short term holiday accommodation to the general public for at least 140 days in the year *[from 06 April 2012 this is to increase to 210 days]*;
- It must be let as such for at least 70 days in the year *[from 06 April 2012 this is to increase to 105 days]*;
- Periods of more than 31 days lettings are allowed so long as they amount to less than 155 days in the year;
- The business must be set up with a view to realising profits.

With regards to meeting the new occupancy thresholds, from 06 April 2012 there will be the opportunity to make an election for a “period of grace”. This will allow your property to be treated as qualifying if you genuinely intended to meet the occupancy threshold, so long as it qualified in the previous year. The election can run for two years if necessary.

Where there is more than one property contained in the FHL business, the owner can elect for “averaging” to apply if the circumstances are such that one (or more) properties qualify but one (or more) does not, but the overall “average” occupancy would mean that all properties qualify.

Once it is established that the property(ies) qualifies to be treated as commercial letting of furnished holiday accommodation, then the benefits accruing are as set out below.

## **INCOME TAX**

### **Expenses**

Expenditure that is “wholly and exclusively” laid out for the purpose of the letting business is allowable as a deduction in computing the annual profit or loss.

Generally speaking then, if you have incurred an expense as a direct result of operating your FHL business, it will be allowable for Income Tax purposes in some form or another. For more detail on the type of expenditure which can be claimed, please refer to our advice sheet “Furnished Holiday Letting Allowable Expenditure”.

Expenses incurred before you commenced trading (for a maximum period of 7 years) may also be allowable if they pass the wholly and exclusively test. Expenditure that enhances the capital value (e.g. extensions, conversions, etc) would not be admissible, but interest paid on loans and normal repairs would usually be allowable, as would any other expenditure that would have been allowed had the business been trading (for example, insurance of the property and contents).

### Depreciation of Furnishings etc (Capital Allowances)

The FHL business owner is able to claim depreciation in the form of capital allowances on the cost of carpets, furnishings, fitted kitchens and bathrooms, integral features etc and this can result in a significant amount of tax relief that is not normally available to non-FHL property businesses.

Enhanced capital allowances in the form of the Annual Investment Allowance are also available for FHL businesses and for 2011-12 tax relief is available on 100% of expenditure on plant and equipment (which for holiday cottage owners includes all furnishings, appliances and integral features – see below) up to a maximum of £100,000. This will be particularly helpful to owners that are just setting up, or are undertaking major refurbishments. For 2012-13 the maximum Annual Investment Allowance reduces to £25,000.

In addition, 100% First Year Allowances are available on certain types of energy saving plant and equipment.

The annual writing down allowance on existing capital allowance pools is 20% for plant and equipment and 10% for Special Rate Pool items (integral features such as water, heating and lighting systems not previously relieved by the Annual Investment Allowance). Note from 2012-13 onwards the pool writing down allowances reduce to 18% and 8% respectively. Both the Annual Investment Allowance and Writing Down Allowances are restricted by the length of the trading period if that is less than one year.

An example of how this works in practice is set out below:-

#### Capital Allowance Pool

		<u>Claim</u>
Balance brought forward	10,000	
Writing down allowance at 20%	( 2,000)	2,000
	8,000	
New expenditure	5,000	
Annual investment allowance	(5,000)	<u>5,000</u>
Balance carried forward	<u>8,000</u>	
Total allowances claimed		<u>7,000</u>

Non holiday letting property businesses cannot claim capital allowances at all on furnishings, irrespective of how much is spent. Instead they receive a 10% wear and tear allowance based on the annual rental income. If that were £10,000 then the allowance would only be £1,000. There is however an alternative basis where the landlord can claim the cost of replacement furnishings only... tax relief on the initial cost of furnishing the property and expenditure on integral fixtures is not available where the property is let as ordinary residential accommodation. The benefit of being able to claim capital allowances is crucial and can often turn a taxable profit into an allowable loss, especially in the early years of the business.

## **Sharing of Profits / Losses:**

Where properties are owned jointly:-

### Qualifying FHL

Profits / Losses can be shared however the partners choose.

### Short-hold Tenancy / Long Let

Profits / Losses must be allocated in property owning ratio. In most married couple partnerships, this will be 50 : 50.

This is another crucial difference between the two options. If the business is operated as husband and wife in partnership, profits can be allocated to the lowest earner, thus minimising tax liabilities. In the long let situation profits and losses must generally be allocated in property owning ratio, unless the owners actually transfer the beneficial ownership of the property and file the appropriate election... this course of action is not necessarily beneficial for all taxes.

The combination of being able to claim capital allowances and scope for sharing income in accordance with owners' agreement gives the FHL business major tax advantages over letting as ordinary residential accommodation and careful management of those two factors should ensure owners legitimately keep more of what they earn from their investment.

## **Treatment of Income as Earnings:**

### Qualifying FHL

Profits treated as income for the calculation of pensionable earnings.

### Short-hold Tenancy / Long Let

Profits treated as investment income only.

Where profits are earned from holiday letting, the recipient of those profits can pay pension premiums based on income that includes the FHL profits. The legislation covering this area is particularly complicated and evolutionary and one should always seek advice from an Independent Financial Advisor.

## **CAPITAL TAXES**

### **Capital Gains Tax**

Qualifying FHL accommodation is treated (and will continue to be after 6 April 2012) as a business asset for Capital Gains Tax purposes, which means...

- a) Capital gains on earlier disposals of any qualifying business assets within the previous 3 years can be rolled over if the proceeds of the earlier disposals are re-invested in qualifying FHL property. This postpones the Capital Gains Tax due on the earlier disposal until such time as the last sale of qualifying assets is made without replacement. By holding on to the business asset, the tax can actually be deferred forever.
- b) Qualifying FHL properties (that have been owned for at least one year) are treated as business assets for the purposes of "Entrepreneurs Relief" under which the first £10million of gains (per person) on business disposals are taxed at an effective rate of 10% compared to 18% or 28% on all other non-business assets. There are qualification criteria to be met in line with the rules for Income Tax and previous gains may affect the amount of relief available.

- c) Intra family gifts of qualifying FHL properties qualify for holdover reliefs as business assets (subject to certain conditions) which again can be used as a tool for postponing Capital Gains Tax. Holdover reliefs are not available on properties given over to long lets.

### **Inheritance Tax**

Qualifying FHL properties that are let for gain on a commercial basis *should* (if the owner is also providing a certain level of services to their guests) be treated as business assets for IHT purposes so long as the property has been owned for more than 2 years. As a qualifying business asset the property would then be excluded from the taxable estate on death.

Simply put, if a couple (married or civil partners) were to jointly leave a home worth £650,000 and also had other chargeable (non-business) assets worth £500,000 then the Inheritance Tax due (assuming two full lifetime exemptions of £325,000 were available on the second death) would be £500,000 x 40% = £200,000. If however, the other chargeable assets were instead qualifying FHL property then the value of the property should be excluded by reason of 100% Business Property Relief and so no Inheritance Tax would be payable on the second death.

This is a hugely important relief and claims are likely to be subject to close scrutiny by the Capital Taxes Office Solicitor and so it is imperative that certain criteria are met to ensure business asset status is maintained. We have produced a separate guide which is available on request (free electronically in PDF format or £5 by post – please make cheques payable to DHC Accounting Limited).

### **Some Non-tax Considerations:**

- FHL undoubtedly requires a higher degree of management than a residential let, however this is not necessarily all bad as it means the owner has regular access to the property for management and maintenance purposes.
- Revenue derived from FHL can be significantly higher than from a residential let, though income cannot be guaranteed and operating costs are generally higher. Choosing the “right” property and providing excellent standards will greatly increase occupancy as furnished holiday accommodation.
- Whilst there is a degree of guaranteed income where the letting is residential, problems can arise with tenants not paying or worse, inflicting terrible damage to a property and eviction can be a very difficult process. Holidaymakers are generally mindful of having a good time and respectful of their accommodation and so much less inclined to cause wanton destruction. And of course their occupation is only short term, so access and eviction can be gained much more easily.

### **Disclaimer**

**The purpose of this guide is to impart basic information only about a huge and complicated subject and we must stress again that you should always take professional advice with regards to tax matters, especially so with regards to the capital taxes where the rules are particularly complex and most subject to change.**

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