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TAXATION OF PROPERTY

TAX ADVANTAGES FOR FURNISHED HOLIDAY LETTINGS

Revised January 2021

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FURNISHED HOLIDAY LETTING AND BUSINESS STATUS

Commercially available furnished holiday letting properties that meet the specified criteria are treated as businesses for Income Tax purposes and also as business property for certain 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 situated 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.

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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 most 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 210 days in the year;
- It must be let as such for at least 105 days in the year;
- 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 these occupancy thresholds there is, if needed, an opportunity to make an election for a “period of grace”. This will allow your property to be treated as qualifying if you genuinely intend to meet the occupancy threshold, so long as it has qualified in a 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”. There have however been changes with regards to tax relief for interest paid by landlords but these do not affect FHL property businesses.(see below).

Landlords: Relief for interest

Interest on loans for the purchase of property has always been allowable as a deduction from profits. However, from 2017/18 residential landlords can no longer deduct interest from profits; instead, they will now obtain a tax credit of 20% of the interest (and other finance costs) paid (so their maximum tax relief is restricted to 20%) rather than 40 or 45% where the owner is a higher rate taxpayer. This measure has been phased in from 2017/18 through to 2020/21.

HMRC have confirmed that FHL properties will however continue to be treated as if a trade and interest and finance costs will continue to be deducted from profit and thus full tax relief is retained.

The fully implemented new provisions (by 2020/21) will operate as follow: -

	<i>Residential Let</i>	<i>FHL</i>
	£	£
Income	12,000	20,000
FHL Expenses - say	<u>-</u>	<u>(8,000)</u>
Profit before interest	12,000	12,000
Interest	<u>-</u>	<u>(10,000)</u>
Net profit	<u>12,000</u>	<u>2,000</u>
Income tax at 40% (Higher rate taxpayer)	4,800	800
Less interest credit (£10,000 x 20%)	<u>(2,000)</u>	<u>-</u>
Net tax due	<u>2,800</u>	<u>800</u>

You can see in the above example that the net profit (after interest paid) is £2,000 in both cases, so the residential let owner is actually paying £2,000 more tax than the FHL owner, and indeed more tax than their actual profit.

Pre trading 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 residential letting businesses.

Enhanced capital allowances on certain energy saving equipment and accelerated capital allowances in the form of the Annual Investment Allowance are also available for FHL businesses. As regards the Annual Investment allowance, 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 £200,000 (from January 2021). This will be particularly helpful to owners that are just setting up or are undertaking major refurbishments.

As stated above, 100% First Year Allowances are also available on certain types of energy saving plant and equipment... HM Government publish an approved expenditure list that can be accessed online.

The annual writing down allowance on existing capital allowance pools is 18% for plant and equipment and 6% for Special Rate Pool items (integral features such as water, heating and lighting systems not previously relieved by the Annual Investment Allowance). 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 18%	(1,800)	1,800
	8,200	
New expenditure	5,000	
Annual investment allowance	(5,000)	<u>5,000</u>
Balance carried forward	<u>8,200</u>	
Total allowances claimed		<u>6,800</u>

Residential property business owners cannot claim capital allowances at all on initial expenditure on furnishings etc, irrespective of how much is spent, but can claim the cost of replacement furnishings only... so 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 a tax 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.

Residential Letting

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 types of letting. If the business is operated by married couples, profits can be allocated to the lowest earner, thus minimising tax liabilities. In the residential 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... but this course of action is not necessarily beneficial for all taxes. Any losses suffered are carried forward and offset against profits arising from the FHL business in later periods and with careful management, this can ensure paying tax on future profits is deferred for several years.

The combination of being able to claim capital allowances and scope for sharing losses and profits in accordance with owners' agreement gives the FHL business owner major tax advantages over letting property 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.

Residential Letting

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 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, this 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 other residential properties (excluding the home). 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 – Business Property Relief

Qualifying FHL properties that are let for gain on a commercial basis *may* (if the owner is also providing a certain and significant 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 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 H M Revenue & Customs will look closely at all such claims given the result of two recent cases decided in favour of HMRC, any claims for this hugely valuable relief are likely to be refused in the first instance and expert advice should be sought.

Some Non-tax Considerations:

- FHL undoubtedly requires a higher degree of investment and 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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