Holiday homes face tax squeeze

HMRC is consulting on its plans for new legislation to replace the current Furnished Holiday Lettings (FHL) regime. Rebecca Benneyworth looks at the current plans and offers her suggestions.

The current tax rules allow furnished holiday letting to be treated as a "quasi trade", with loss reliefs available as if the activity were a trade and a number of CGT reliefs applying to disposals. Those letting out homes can also claim plant and machinery allowances for expenditure on furniture and equipment, and in particular the Annual Investment Allowance.

The changes are needed because the regime needs to apply to the rest of the European Economic Area rather than the UK only. If extended as they currently stand, the FHL rules would be a serious drain on tax revenues as owners of holiday homes abroad offset any losses incurred against UK income.

Holiday homes are an important part of the UK tourist industry and provide jobs in rural areas throughout the country. The Treasury has a difficult task to come up with new legislation that satisfies Europe without damaging the UK economy, but also minimises the potential for inappropriate exploitation of the new rules.

The proposals
The **latest FHL proposals** (1.9MB PDF) seek to tighten up the conditions under which the favourable tax regime can apply, and to modify the rules on loss relief as follows:

- A qualifying property must presently be available for letting to the public for 140 days a year. It is proposed that this is increased to 210 days a year – 30 weeks.
- A qualifying property must actually be let to the public for 70 days a year – this will increase to 105 days or 15 weeks.
- Losses made in a UK or EEA FHL business will be restricted so that they can only be set against profits from the same FHL business. This ends the favourable loss relief available on FHL activities.
-

Other proposals formalise the treatment of capital allowances. Under the FHL rules, a property must meet the letting conditions in order to claim capital allowances in the year; strictly there should be a disposal of the assets on which allowances have been claimed when the letting period drops below the required level, as these assets no longer qualify for allowances. HMRC has taken a concessionary approach when a property fails to qualify for what is anticipated to be a temporary period, but this approach needs formalising.

The new capital allowance rules propose that the plant which qualifies under the FHL regime, but not under normal letting rules, is maintained in a separate pool or pools. No allowances are granted in periods for which the property does not qualify, but additions to and disposals from the pool are dealt with in the period, the written down value being brought "on stream" again when the property once again qualifies.

Practical problem 1: Availability and actually let changes
Increasing the available and actually let periods by 50% may not have a significant effect on those letting commercially, but may well eat into the time available to a family which occasionally lets out a holiday home. This approach seem appropriate, as the favourable tax treatment should really extend to those operating in this area as a commercial activity.

Families who rent out their holiday homes but are not able to meet the new higher letting rates would simply declare the income as rental income, and set any losses against their net rental income of the year of the loss and subsequent years.
But how will the extended availability and letting periods affect the purely commercial operator? Some businesses operate all year round and will have no problem meeting the "available for letting to the public" condition; this still leaves a period during which the property can be overwintered, or when the owners could spend time there off season.

Let's consider the "actually let" condition. The tax year is the basis for the test – let's look at a few recent tax years, taking the period from April to October half term as an example.

	Good Friday	Tax year	No of weeks	Required occupancy
2007	6 April	2007/08	29	52%
2008	21 March	2008/09	30	50%
2009	10 April	2009/10	29	52%
2010	2 April	2010/11	29	52%

However, of this period, a total of around 10 weeks represents school holidays, so those operators targeting the family market need to achieve close to 100% occupancy during that period, leaving them to find a further 5 weeks outside school holidays to meet the letting capacity required.

A very late Easter at the end of April would increase the required occupancy rate by reducing the number of weeks in the main letting period. Family lets could face a problem when Easter falls very early, putting two school Easter holidays in one tax year, at the expense of the years either side. Where there is no school Easter holiday in a tax year the number of school holiday weeks falls to 8 and the owner would need to find a further 7 weeks of lettings to make up the required period.

While some operators manage to let properties all year, trade bodies and those within the commercial sector will need to confirm that the new conditions are reasonable for the wider industry.

Practical problem 2: Losses
No commercial operator goes into this business to make a loss. But keeping holiday properties which are solely for letting and not for family occupation up to the standard that guests expect is an expensive business. Properties have to be redecorated regularly, and guests expect high quality appliances and fittings, good quality linen and so on.

Domestic grade furniture is not robust enough to cope with holiday makers' heavy use, so operators need to invest in hotel standard furnishings. A commercial operator faced with refurbishing several properties could well incur a loss. Restricting losses to FHL activities will bring down the cost to the Exchequer, but will put commercial operators in a worse position than a "pure" rental landlord who can set a loss on rental activities against other rental profits (segregating UK and non-UK rental businesses and the offset of losses).

Under the proposals, a commercial operator would not be permitted to set a loss on his FHL activity against any other pure rental profits – even those relating to FHL properties which have not met the relevant conditions in that year. Floods, foot and mouth disease and other complications could lead to losses for operators in the "wrong" area.

The losses issue made me wonder whether the new legislation is right for commercial operators of multi-property sites. Is it not time to recognise that what these businesses are doing is, in fact trading? A site with eight properties, tended by full time maintenance and cleaning staff and let throughout the year is surely a trade? I move that we come up with a clear definition of this activity and move it out of any concessionary treatment into full trading treatment.

The definition would need to be clearly drawn so that operators know which side of the line they fall (probably excluding owner occupation as a starter). These businesses would get the support they need, without extending the reliefs to those who are effectively letting an investment property.

What about single property owners, who represent an important part of the tourist business, but who do not fall into the trading definition? These new FHL proposals seem fair enough in that light – in exchange for favourable capital allowances and CGT treatment, these owners face a restriction on their losses if they incur any.

Practical problem 3: Capital allowances

For a single property owner, the proposal for a separate pool of expenditure which will only qualify if the FHL conditions are met seems a sensible one, and the simplest way to overcome the current practical problems with applying the strict letter of the law. Of course there may need to be two separate pools if the businesses has claimed allowances on integral features.

Provided the true trading businesses are segregated as outlined above, I would go further than the current proposals. Where assets are used in a tax year for letting which does not constitute FHL activity (due to the conditions not being met) I would suggest that the pool of expenditure is reduced in any event by a Writing Down Allowance, which is not available as a tax allowance, but reflects the non qualifying use of the assets concerned. Otherwise, eventually the owner will claim for the full cost of the assets, and no recognition of use for non-qualifying purposes will ever be made.

There is one major flaw, however, in the “notional pool” approach as the consultation document calls it. If the owner has, say three properties in different locations, each of which may or may not qualify as FHL from one year to another, surely six separate pools will now be needed to reflect the need to claim allowances or not in respect of each property each year. This flaw is present irrespective of whether my suggestion that a WDA is applied in any event; I cannot see a solution to this and surely many will claim that this adds too much complexity. I still think the separate pool idea is a very neat solution to the current problem, but it does present challenges of its own.

Rebecca Benneyworth , Accountancy Web, 12-Aug-2010