**Tourism**Alliance
***the voice of tourism***

# FHL Rules

## 1. Background

This paper sets out information on the difference between self-catering and residential letting and the financial impact to self-catering operators should the Furnished Holiday Lettings (FHL) Rules be repealed.

At present, tax law divides income derived from accommodation businesses into either property investment income (eg.,rent derived from buy-to-let properties) or trading income (almost every other business activity including income from a bed & breakfast or a hotel).

The Tourism Alliance contends that FHL properties have much more in common with hotels and bed & breakfasts which are ordinarily regarded as trading businesses, than they do with residential properties which are ordinarily regarded as investment businesses. In particular, VAT is charged at the standard rate, while rents of residential properties are exempt from VAT.

Indeed, the establishment of the FHL Rules by the Government in 1984 was in recognition that self-catering properties were distinct from residential properties and should be treated as ordinary trading businesses for tax purposes.

Therefore, in the repealing of the FHL Rules, consideration needs to be made to ensure that *bona fide* self-catering businesses continue to be recognised as an important component of the UK tourism industry with brings revenue and employment for example to rural and seaside areas.

## 2. Impact of Repealing the FHL Rules

### a. Changes in the Tax Treatment of Self-Catering Properties

For the operators of self-catering businesses to benefit from the tax advantages of being treated as a trading business, they must satisfy certain rules as set out in the Income Tax (Trading and Other Income) Act 2005. These rules specify that, to qualify for such treatment, the self-catering property must:

- Be available for holiday letting for at least 20 weeks every year
- Be let as a holiday letting for at least 10 weeks per year
- Not be let to the same occupant for more than 31 days in a continuous period
- Be run with the intention of generating a profit

If operators are able to satisfy these conditions, the income derived from the businesses is treated as a "trading income" rather than "property investment income" for tax purposes.

The repeal of the FHL Rules would have a number of impacts upon the tax treatment of self-catering businesses, particularly in relation to Income/Corporation Tax and Capital Gains Tax.

(See Appendix A for a fuller assessment of the tax consequences.)

**b. Financial Impact of These Tax Changes**

The financial implications of changes to the tax treatment of self-catering properties is difficult to determine due to the specific circumstances of each business. However, an example has been constructed to highlight the difference in how self-catering business operators would be taxed, and the significant impact that this would have on their viability, if the FHL Rules were repealed.

This example uses two scenarios, one under the current taxation regime (Pre-Repeal) and the other if the FHL Rules are repealed and no measures are implemented to mitigate the impact (Post-Repeal).

In each scenario, the operator starts the business in Year 1 and operates it under same trading conditions for five years with a large capital replacement project (in this case, the replacement of the kitchen) before disposing of the business in Year 5.

The difference in income tax treatment means that, under this example, the self-catering operator is between £8,000 and £16,000 worse off as a consequence of the changes in the income/corporation tax treatment of the business and, assuming a £50,000 capital profit on the disposal of the property, between £4,000 and £9,000 worse off as a result of the changes in Capital Gains Tax Treatment, depending upon whether or not the proceeds of the sale were to be re-invested.

Overall, therefore, if the FHL Rules are repealed and no mitigating action is taken, a person who buys a self-catering business, and runs it for five years before selling on, will be between £12,000 and £25,000 worse-off as a consequence.

(See Appendix B for full details)

**c. Impacts on the Self-Catering Sector**

The changes in the tax treatment of self-catering businesses will have two main impacts of the self-catering sector.

***i. Reduced Entry into the Sector***

The self-catering sector is an increasingly significant component of the UK holiday market, generating revenue of £1.8bn per annum (almost 13% of all UK domestic holiday expenditure). Along with budget hotels, camping and caravanning, the sector is one of the growth areas of the UK tourism industry as

UK residents are increasingly looking for high-quality, cost-effective options for taking family holidays. Moreover many families prefer the greater freedom and informality of self-catering accommodation as opposed to hotel or bed & breakfast accommodation.

This is borne out by the latest UK Tourism Survey data which shows that over the 2009 summer period, holiday travel using self-catering premises has increased by around 20% over the previous year.

However, although demand for this type of holiday is increasing, start-up costs are high due to the price of suitable properties and the need to undertake refurbishment to the high quality expected by today's customers. The availability of capital allowances and loss reliefs can reduce the cost of setting up a business

by up to 40%, encouraging new entrants into the market. Reducing these benefits would reduce the attractiveness of the sector for further investment and, consequently, reduce the number of new entrants.

If Capital Gains Tax was applied at the full rate, the attractiveness of the sector to new entrants would be further eroded and many people already operating self-catering businesses would be penalised. As a consequence, there would be a reduction in the number of self-catering businesses, which would negatively impact upon local economies which are dependent upon tourists who use this form of holiday accommodation.

*ii. Reduced Investment in the Property*

One of the core goals of the Government in regard to its tourism responsibilities under the Tourism Development Act has been to increase the quality of tourism products and service to make the UK tourism industry internationally competitive.

The level of investment required to operate and maintain a self-catering property to the standards set down by the national Quality Assessment Scheme administered by VisitEngland and the quality expected by customers is significant.

Bed linen, towels, crockery and cutlery require replacing on average two/three times per year, while washing machines, dishwashers, flat screen tvs, music centres, furnishings, carpets, beds, only have a 3-year life span before the need for replacement and refurbishment.

Changing from 100% relief on capital expenditure to the proposed 10% wear and tear allowance means that the quality and quantity of the fittings provided will be reduced and there will be a lower level of maintenance. This will adversely affect the quality of the tourism product and the experience that customers receive.

We are confident that alternative proposals can be identified that will both comply with EU requirements and protect tax revenue without damaging the self-catering sector or the rural and seaside tourism economies that depend on tourists who use these properties.

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## Appendix A – Main Tax Consequences of Repealing the FHL Rules

**1. Income/Corporation Tax**

The FHL activity will no longer be treated as if a trade and consequently the letting will form part of a property investment business. The main consequence of this will be that if the underlying activity is not a trade in its own right then:

i. income losses will not be available for set-off against other classes of income; and
ii. certain capital allowances may longer be available [1];
iii. income is not longer relevant earnings when calculating maximum annual contributions to pensions qualifying for relief

**2. Capital Gains Tax**.

The follow issue will arise on the major reliefs on the assumption that the FHL activity is not a trade in its own right.

a. For **roll-over relief**, gains attributable to periods when the FHL Rules were in force and were satisfied will continue to qualify for roll-over relief because
   i. there is a specific apportionment rule [2]; and
   ii. there is no requirement that the asset be in trade use at the time of disposal [3].

<u>BUT</u> for gains arising in period when the FHL Rules are withdrawn

   iii. FHL will no longer qualify as the 'new asset', ie, as an asset the acquisition of which enables gains to be rolled-over *into* the acquisition cost (ie, be a place to park money from the sale of other assets); and
   iv. the gains on the FHL property attributable to period after the FHL Rules have been withdrawn will in future not be capable of being deferred in future.

b. Gains arising on FHL property will continue to qualify for **general hold-over relief** because this is available where there is a chargeable transfer [4] and hence is unaffected as it is not dependent upon the status of the asset.

c. For **specific hold-over relief** [5] for agricultural and business property, the position is more complex. This relief is generally available when property is gifted during the donor's lifetime as a *potentially exempt transfer.*
   i. Where the FHL property is gifted on its own the relief is immediately withdrawn when the FHL Rules are withdrawn. This follows because of the normal requirement that the asset is in trade use at the date of the gift [6].
   ii. Where, however, the FHL property is part of an asset that includes agricultural property for inheritance tax purposes then relief may still be obtained provided the ex-FHL property is transferred with property to which the agricultural property extension [7] applies, ie, provided at least part of what is gifted would be reduced

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[1] Though allowances may become available.
[2] TCGA 1992 x 152(7).
[3] The authority for this is the case of *Richard J Lyons & Co Ltd* ([1989] 62 TC 261).
[4] TCGA 1992 s 260.
[5] TCGA 1992 s 165.
[6] A point confirmed at HMRC's instructions at CG 66950. and probably correct in view of the legislation referring to the requirement that relief applies to an *'…asset, or an interest in an asset, used for the purposes of a trade…'* in TCGA 1992 s 165(2)(a).
[7] Ie., under TCGA 1992 Sch 7 para 1.

by APR if the gift were a chargeable transfer and the normal specific hold-over relief deferral rules do not apply [8].

d. Gains on FHL property will no longer qualify for **entrepreneurs' relief** because:
   i) If the disposal is of other than shares, then the *relevant business asset* rules apply [9] which require the asset to have been in use for a business, which in turn [10] requires the business to be a *trade, profession or vocation*. Though it is a mute point as to whether the deemed trade period is retained for FHL property prior to its withdrawal and this could be relevant to:
      (1) a post-cessation disposal of an asset that was in deemed trade use; or
      (2) if, exceptionally, the FHL property falls into trade use in the future for the purposes of an apportionments under the TCGA 1992 s 169P rules (eg., not in trade use throughout the period of ownership).

   ii) If the disposal is of shares then the company then the company has to be a trading company or the holding company of a trading group [11].

[8] Ie, that relief is not due because the property is property used in a trade, which prevent the 'agricultural property extension' from over-riding the rule of trade use at the time of disposal.
[9] TCGA 1992 s 169L
[10] TCGA 1992 s 169S(1)(a).
[11] TCGA 1992 s 169I(6)(a).

## Appendix B – Financial Implications of Repealing the FHL Rules

### 1. Income Tax Considerations

This example uses two scenarios, one under the current taxation regime (Pre-Repeal) and the other if the FHL Rules are repealed and no measures are implemented to mitigate the impact (Post-Repeal). In each scenario, the operator starts the business in Year 1 and operates it under same trading conditions for five years with a large capital replacement project (in this case, the replacement of the kitchen) before disposing of the business in Year 5.

| **Year 1** | **Pre-Repeal** | **Post-Repeal** |
|---|---|---|
| Income(1) | 10,000 | 10,000 |
| Overheads(2) | (15,000) | (15,000) |
| Trading loss | (5,000) | (5,000) |
| Setting up costs(3) | (35,000) | (35,000) |
| First year total loss | £ (40,000) | £ (40,000) |

**Notes**

(1) Income
It has been assumed that in both cases, the business will generate the same level of income and this being the first period of trading, this tends to be low given the lead time building up to the "normal" level of income.

(2) Overheads
These are non-specific, but would include all operating expenses and interest on borrowings (including those incurred in the pre-trading period).

(3) Setting up Costs
These comprise items such as all carpets, furnishings and appliances, plus central heating, fitted kitchens and bathrooms, upon which Annual Investment Allowances would be available at 100% of cost.

Currently, the operators of the FHL business would be able to offset their full loss of £40,000 against other earnings to obtain tax refunds of between £8,000 (at 20%) and £16,000 (at 40%) thus considerably reducing the initial cost of setting up the business. This is exactly the outcome our system of loss reliefs is designed for… to encourage people to take risks by making the investment required to start up a new business.

However, post repeal the FHL business owner will no longer be able to claim allowances for the setting up costs and the only relief available will be to carry forward the first year trading loss of only £5,000 to be relieved against future profits from the letting business only.

No relief will be available on the £35,000 of setting up costs and the owner of the FHL business will initially be worse off by between £8,000 and £16,000 at the time when the business is in most need of funds.

| **Year 2** | **Pre-Repeal** | **Post-Repeal** |
|---|---|---|
| Income | 15,000 | 15,000 |
| Overheads | (15,000) | (15,000) |
| Trading Profit / Loss | £ - | £ - |

Assuming that there is no capital expenditure in Year 2, both businesses break even and neither operator would have any tax to pay or refunded.

In the post-repeal case, the business operator's first year loss of £5,000 would be carried forward (i.e. not relieved in any way).

| **Year 3** | **Pre-Repeal** | **Post-Repeal** |
|---|---|---|
| Income | 20,000 | 20,000 |
| Overheads | (15,000) | (15,000) |
| Trading Profit | 5,000 | 5,000 |
| Replacement furnishings | (2,500) | (2,500) |
| (assume 100% deductible)* | £ 2,500 | 2,500 |
| Loss brought forward | | £ (2,500) |

* With regards to the allowance for replacement furnishings, the FHL owner could either claim for 100% replacement costs (as above) or a writing down allowance calculated at 10% of the net income, which would have been worth £500 only in the above example. The two methods of claiming allowances are not interchangeable and the owner has to decide at the outset which to use.

In the Pre-Repeal scenario, the operator would have a tax bill of between £500 (at 20%) and £1,000 (at 40%) subject to other earnings, while in the Post-Repeal scenario, the operator would have no tax bill and the loss being carried forward would reduce to £2,500.

| **Year 4** | **Pre-Repeal** | **Post-Repeal** |
|---|---|---|
| Income | 25,000 | 25,000 |
| Overheads | (15,000) | (15,000) |
| Trading Profit | 10,000 | 10,000 |
| Replacement furnishings | - | - |
| | £ 10,000 | 10,000 |
| Loss brought forward | | (2,500) |
| Profit | | £ 7,500 |

In the Pre-Repeal scenario, the operator would have a tax bill of between £2,000 (at 20%) and £4,000 (at 40%) subject to other earnings, while in the Post-Repeal scenario, the owner would have a tax bill of between £1,500 (at 20%) and £3,000 (at 40%) subject to other earnings.

| Year 5 | Pre-Repeal | Post-Repeal |
|---|---|---|
| Income | 25,000 | 25,000 |
| Overheads | (15,000) | (15,000) |
| Trading Profit | 10,000 | 10,000 |
| Replacement kitchen | (15,000) | (15,000) |
| | £(5,000) | £(5,000) |

In the Pre-Repeal scenario, the operator would obtain a tax refund of between £1,000 (at 20%) and £2,000 (at 40%) subject to other earnings, while in the Post-Repeal scenario, the operator would have no tax to pay and the loss of £5,000 would be carried forward. If however the owner had opted for the 10% Wear& Tear Allowance (instead of renewals basis) at the outset, the owner would have actually had a tax bill of between £1,800 and £3,600.

**Five Year Income Tax Summary**

| | Pre-Repeal | | Post-Repeal | |
|---|---|---|---|---|
| | **Min** | **Max** | **Min** | **Max** |
| Year 1 | (8,000) | (16,000) | Nil | Nil |
| Year 2 | Nil | Nil | Nil | Nil |
| Year 3 | 500 | 1,000 | Nil | Nil |
| Year 4 | 2,000 | 4,000 | 1,500 | 3,000 |
| Year 5 | (1,000) | (2,000) | Nil | Nil |
| **Net tax cost / (benefit)** | **£(6,500)** | **£(13,000)** | **£1,500** | **£3,000** |

In the Pre-Repeal scenario, the operator is clearly much better off in respect of cost and a return on their investment. Going forward, once the initial loss has been fully relieved, both entities should pay the same amount of tax (so long as the FHL owner has adopted the renewals basis for claiming for capital expenditure) and of course, assuming profits continue to be made.

The difference in income tax treatment means that, under this example, the self-catering operator is between £8,000 and £16,000 worse off as a consequence of the repeal of the FHL Rules.

## 2. Capital Gains Considerations

This consideration of the capital gains impact of repealing the FHL Rules assumes that the initial purchase / construction cost is £300,000 and the property is worth £350,000 after 5 years when the owner wishes to sell the property and retire. It also assumes that the owners have other disposals, such that the whole of the gain would be taxable at the going rate.  The capital gains tax calculations would therefore be as follows:-

**a. Pre-Repeal**

Subject to previous disposals, the owner would be able to claim Entrepreneurs Relief which would reduce the effective Capital Gains Tax Rate to a maximum of 10%

| | |
|---|---|
| Profit on disposal | 50,000 |
| Entrepreneurial relief (4/9) | (22,222) |
| Taxable gain | £ 27,778 |

| | |
|---|---|
| Capital gains tax at 18% | £ 5,000 |

The owner could presently, if inclined, re-invest the sale proceeds in new business assets and reduce the taxable gain to £Nil.

**b. Post-Repeal**

No available reliefs.

| | |
|---|---|
| Profit on disposal | £ 50,000 |

| | |
|---|---|
| Capital gains tax at 18% | £ 9,000 |

There will no longer be any reliefs for re-investing in new business assets, so further investment would not be actively encouraged.