MEMORANDUM OF ADVICE
RE: FURNISHED HOLIDAY LETTINGS

OPPORTUNITY TO AVOID/MITIGATE POTENTIAL INHERITANCE TAX CHARGE

POTENTIAL TAX SAVING OF UP TO £260,000 FOR A MARRIED COUPLE/JOINT OWNERS

FEBRUARY 2010

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MEMORANDUM OF ADVICE
FURNISHED HOLIDAY LETTINGS

The Inland Revenue (“HMRC”) has recently announced fundamental changes to the rules affecting the taxation of properties used for furnished holiday lettings (“FHLs”) which will take effect from 6th April 2010. The background to this change is that the European Parliament ruled that it was not lawful for HMRC to distinguish between FHLs situated in the UK (which are treated as businesses) and those situated in other member states of the European Union (which are not). Up to now HMRC has accorded more favourable tax treatment to FHLs situated in the UK. You will not be surprised to hear that, rather then extending this favoured tax status to FHLs situated in all member states, HMRC has decided instead to withdraw the beneficial tax treatment of FHLs situated in the UK!

Incidentally this does meant that, if you do own an FHL situated in another member state, you may be entitled to claim an income tax refund back-dated to April 2003. Please contact us or your Accountant if you think that you may want to make a repayment claim.

Current “business” status of FHLs to change

FHLs situated in the UK are currently treated as “quasi-business” assets for income tax and capital gains tax (“CGT”) purposes provided that certain conditions are met as follows:-

(a) It must be available for commercial letting as holiday accommodation for at least **140** days a year;

(b) It must actually be let as holiday accommodation for at least **70** days a year; and

(c) It must not normally be let for a continuous period of more than **31** days to the same tenant.

Tax benefits of “business” status

If those conditions are met, the tax benefits are as follows:-

CGT

The following reliefs can be claimed:

(a) **Entrepreneurs' Relief.** This reduces the tax payable on the sale of a FHL to an effective 10% rate (as opposed to the standard 18% flat rate). Please note, however, that HMRC has (generously!) announced that Entrepreneurs' Relief can be claimed on an "ex-FHL property" that is sold within 3 years of the rules changing (i.e. before 6 April 2013). This concession was designed to prevent a mad scramble by FHL owners to sell before 6 April this year which might have caused a collapse in the FHL market particularly as many experts are predicting that CGT rates are likely to be increased in the next Budget.

(b) **Roll-Over Relief.** This allows gains arising on the sale of a FHL to be deferred if the proceeds of sale are reinvested in other business assets e.g. a farm or AIM shares within specified time limits; and

(c) **Business Hold-Over Relief.** This allows the accrued gains arising on a lifetime gift of a FHL (or a share therein) to be deferred so that no tax charge arises until the donee subsequently disposes of the FHL.

Income Tax

(a) Losses from FHLs can be set against other income;

(b) Capital allowances are available; and

(c) Income from FHLs is treated as "relevant earnings" for pension purposes.

The new regime post 5 April 2010

However, these tax benefits will cease to be available from 5th April 2010, when FHLs will become a thing of the past. HMRC will thereafter treat FHLs as investments (i.e. a landlord and tenant situation) rather than businesses and a "wear and tear" allowance will replace capital allowances.

There will be a new regime of Furnished Holiday Businesses ("FHBs") but in order to qualify as a business the owner must be able to demonstrate to HMRC that he is

running a genuine commercial business – "an undertaking that involves risks and service to the client" i.e. he must show that he is doing more than merely receiving rent. HMRC has already indicated that in future FHLs which qualify as businesses will be the exception rather than the rule.

HMRC has said that it will in future look at each case on its merits and all owners therefore now need to consider carefully, with the benefit of proper professional advice, how their FHLs are likely to be regarded by HMRC in the future. There will also be other tax issues to consider e.g. VAT, National Insurance and, of particular importance for older owners of FHLs, **Inheritance Tax ("IHT").**

Inheritance Tax

Unlike CGT and Income Tax, there is no specific IHT legislation governing FHLs. **Business Property Relief ("BPR")**, at 100% is currently available provided that the owner can show that he/she is running a business. The Revenue Manual states that it helps if there are three or more properties, if the "lettings" are part of a larger business (e.g. a farm) or if services are provided to holidaymakers either personally by the owner or via an agent. BPR is normally allowed at present where the lettings are short term (e.g. weekly or fortnightly) and where the owner (either himself or via an agent who can be a relative or a housekeeper) is substantially involved with the holidaymakers in terms of their activities at and from the property. This can involve arranging leisure activities or trips or the provision of meals, baby sitting or maid service etc. BPR is unlikely to be available where no services are provided, where lettings are to friends or relatives or where the lettings are longer term (e.g. assured shortholds).

HMRC has indicated that FHLs/FHBs will be looked at much more closely in the future and have stated that they believe that in the past BPR has been allowed in many cases where, on reflection, they now consider that relief should not have been given. It is also possible (if not quite likely) that HMRC may introduce specific IHT legislation in the future preventing owners of FHLs from claiming BPR in the same

way that they are now taking away the formal “business” status of FHLs for CGT and Income Tax purposes.

Where does this leave owners of FHLs going forward?

Many owners of FHLs will have been counting on getting BPR on death but this now appears uncertain at least in the majority of cases. Also, as people get older, they often find that the demands of dealing with holiday lets become too onerous and wish to change to longer term lets. If they do that of course, then BPR will not be available on death no matter how long they may have carried on the holiday letting business in the past.

In many cases, owners who are doubtful that their FHLs will continue to benefit from BPR in the future, may consider passing their FHLs down to children or grandchildren. As explained below, the precise way in which this should be done requires very careful consideration. There is an opportunity, in the short period of time leading up to the end of this financial year, or to be safe, the Budget (the date of which has not yet been announced but is likely to be in the first half of March) to take advantage of a curious anomaly in the IHT legislation, which could produce a very significant IHT saving of up to **£260,000** in the case of a married couple or other joint owners.

Avoiding a “Reservation of Benefit”

Please note that, as with any gift, it will not be effective for IHT unless the donor is prepared to give up the income from the FHL. Otherwise, the gift will be caught by the so-called “reservation of benefit” rules which prevent people avoiding IHT by giving away assets but continuing to derive a benefit from them e.g. if you give away your home to your children but continue to live in it rent free then your home will still be subject to IHT on your death. However, if the giving up of income is a concern it may be possible to mitigate the effect of this by transferring the FHL at an undervalue rather than gifting it. This will require careful consideration and specialist advice. However, even if an owner decides that he is happy to give up the income

and give the FHL away now, without proper planning there could still be a nasty sting in the tail as explained below.

The clawback trap

Let us suppose that a husband ("H") and wife ("W") have owned FHLs for many years in equal shares which they believe currently qualify for BPR at 100% but are concerned about the future IHT position. They decide that they wish to pass on the FHLs to their adult children before 6th April 2010. H and W are both elderly and are concerned that they may not survive for the requisite period of 7 years from the making of the gifts.

Accordingly, on 1st April 2010, without taking specialist advice, H and W give their FHLs (then valued at £650,000) to their children. Each of them accordingly makes a gift (known as a Potentially Exempt Transfer ("PET")) of £325,000, which qualifies for 100% BPR. No IHT is payable at the time the gift is made and, as explained above, CGT holdover relief will be available to defer any CGT charge on the gain if, as is likely, the FHLs have increased in value since the date of acquisition. Subsequently, in March 2011, both H and W are unfortunately killed in a car crash. Provided that the FHLs still qualify for BPR and are still owned by their children at the date of death then no IHT will be payable on those gifts.

However, if the law has by then changed or HMRC otherwise determines that at the date of death the FHLs no longer qualify for BPR then the position is quite different. This is because of what is known as "clawback". Effectively, if the FHLs no longer still qualify as business assets on death then the BPR claimed on the original gift is clawed back with disasterous IHT consequences. Although there will be no IHT payable on the gifts of the FHLs themselves because each gift is covered by the donor's nil rate band (currently £325,000 and frozen at that level for the 2010/2011 tax year), both nil rate bands will then have been fully used up so that the whole of H and W's death estates will be subject to tax at 40%. In short, the gifts of the FHLs have not avoided any IHT but have simply used up H and W's respective IHT thresholds. Of course, had H and W both survived for 7 years then the gifts would

have been fully tax effective and would not have used up H and W's nil rate bands but there is always a risk, which obviously increases as the donor gets older.

How can this risk be avoided?

Let us assume the facts are the same as before, but the gifts of the FHLs to the children are made instead into a trust (either a life interest or a discretionary trust can be used). Again, no IHT is payable at the time of the gifts because 100% BPR applies. On death, clawback applies as before to the gifts but as these are within H and W's respective nil rate bands, no IHT is payable on them. However, (and this is the good bit!) the IHT rules make a distinction between outright gifts and gifts into trust, the effect of which is that the clawback does not affect H and W's cumulative totals for the purposes of calculating the IHT due on their estates. In other words, this time IHT on the death estates is calculated on the basis that <u>no use</u> has been made of H and W's respective IHT nil rate bands and these therefore remain fully available to set against the value of their estates.

This results in a potential combined IHT saving of £260,000 at current rates. This unexpected (but very desirable) result is achieved because of an anomaly in the legislation which limits the operation of the clawback where business assets (in this case FHLs) are gifted to a trust rather than to an individual.

Please note that if the value of the FHL exceeds £325,000 (the current IHT threshold) when it enters the trust, then if it subsequently ceases to qualify for BPR at 100%, it is likely that there will be an IHT charge when the trust is wound up. This is because trusts have their own separate IHT regime. However, as the rules stand, this will almost certainly be at a relatively modest rate only as the maximum rate of IHT payable in respect of trusts is only 6% (and will generally be lower than that) compared to a 40% charge on death. If applicable, we can give further advice about the likely level of IHT charge in the trust once we know the value of the FHL.

Do I have to take action before 6 April 2010?

Please note that hold-over relief will still be available for CGT purposes even if the gift is made on or after 6th April 2010 as all gifts into trust qualify for hold-over relief even if the asset being transferred is not (or has ceased to be) a business asset. However please note that the beneficiaries of the trust cannot include the creators of the trust or their minor children (or at least the latter cannot benefit from the trust until they attain 18) if CGT hold-over relief needs to be claimed.

However, as mentioned above, we do still recommend that any gifts of FHLs into trust are completed before 6th April 2010 (and preferably before the Budget in March) just in case the loophole is blocked or the rules change adversely in some other way. It is of course always possible, but hopefully unlikely, that the loophole could be blocked retrospectively.

It is probably also correct to say that HMRC is more likely to accept a claim for BPR if the gift is made before 6 April 2010. This is particularly important where the value of the FHL exceeds £325,000 (or £650,000 in the case of a married couple or joint owners). Otherwise an immediate IHT charge will arise on the creation of the Trust. We will have to look at each case separately in order to advise as to whether or not a claim for BPR now on a transfer of the FHL into trust is likely to succeed.

How much will it cost?

As you will by now appreciate this is a very technical area and the difference between getting it right or wrong could be very significant in terms of your IHT bill. We will charge a flat fee of 1½% of the current value of the FHL plus VAT and disbursements. Our fee covers the preparation of all legal documentation and Inland Revenue forms and associated tax advice. There is a minimum fee of £3,000 + VAT. Disbursements will include Land Registry fees which will vary according to the value of the FHL and whether the title of the FHL is already registered at the Land Registry. Please note that if the FHL is to be transferred into the trust at an undervalue (as opposed to a straightforward gift) the fee will increase to 2% of value plus VAT and disbursements (with a minimum fee of £4,000) as this will involve

further specialist tax advice and the preparation of additional documents.

What do I do now?

If you are worried that you may be adversely affected by the forthcoming changes to the tax treatment of FHLs and in particular the potential loss of BPR on death and would like to discuss the mechanics and implications of making a gift or transfer at an undervalue of your FHL(s) into trust now please contact either **MIKE STOCK** at our Abergavenny office or **SARAH GILES** at our Crickhowell office.

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