

Capital gains tax and holiday homes

The announcement that capital gains tax is to be increased for investment assets, including second properties and holiday homes, has caused a significant amount of consternation in the national press. There have been reports of properties being put on the market for sale at greatly reduced prices in order to secure the benefit of the current low rate of capital gains tax. However; well-advised property owners need not take such extraordinary and drastic action since the benefit of the current capital gains tax rate can be secured by transferring the property into a suitably drafted short term trust.

Those with holiday homes could also review whether it might be possible to bring the property concerned within the scope of the legislation relating to furnished holiday lets. The conditions to be satisfied are not as onerous as one might expect, and the available tax reliefs are very generous. These reliefs were due to be withdrawn with effect for the current tax year, but on the change of government they have been given a reprieve. Accordingly they should continue to be available throughout the life of the current Parliament. In fact, the reliefs have been widened and are now available in respect of properties abroad, as well as properties in the United Kingdom.

The main condition which must be satisfied is that the property must be actually let for 70 days in the relevant 12-month period (normally the fiscal year). Those lettings must be on a commercial basis and to the public generally as holiday accommodation, with no one occupant staying for more than 31 days. It will be appreciated therefore that so long as the property is let to the public throughout, for example, July and August plus 8 days in September, with no-one staying for more than 4 weeks, these tests will be satisfied.

There is a secondary test that the property must be available for commercial letting to the public for at least 140 days in a 12-month period. Normally unless the property owner and his or her family use the property extensively throughout the year, it will not be difficult to show that it was available for letting for an additional 70 days in addition to the 70 days of actual letting.

It is a fallacy to consider that the relief is only available for properties in holiday areas, such as seaside towns and other popular holiday destinations. There is no such requirement and the property can be in an inner city area. The reliefs apply to properties in the UK or elsewhere in the European Economic Area.

Once the tests are satisfied, the property will be treated for tax as used for the purposes of trade. This in turn will mean that any capital gain realised on the property and apportioned to the 'trading period' of ownership will almost certainly not be within the anticipated increase in the capital gains tax rate.

The treatment of the income as trading income also brings with it substantial advantages for income tax purposes. The most important of these is that capital allowances can be claimed in respect of all plant and machinery

purchased for the purposes of the lettings. In practical terms this can mean that the cost of all furniture and equipment purchased for use in the property can effectively be deductible from rents as an expense. The claim will be via the provisions relating to annual investment allowances to which an upper limit of £50,000 per annum applies, but it is unlikely that this will be exceeded in the case of a furnished holiday let. For income tax purposes, the letting income also counts as earned income against which personal pension contributions can be made.

It should be noted however that private use adjustments should be made in all tax computations relating to furnished holiday lets where the property is used by the owner or his or her family.

On the sale of a furnished holiday let, it is possible to avoid all liability to capital gains tax by means of capital gains tax 'rollover relief'. If the proceeds of sale are reinvested in another property, which, on acquisition, is used for furnished holiday lettings (as defined above), a claim can be made for the capital gain on the property sold to be deducted from the acquisition cost of the new property. The result is that no tax is payable by virtue of the sale. It should be noted that rollover relief is not withdrawn if at a later time the property ceases to be used for furnished holiday lettings.

Although there are significant income tax and capital gains tax reliefs for furnished holiday lets, the same is not true in relation to inheritance tax. At one time HMRC were willing to accept that furnished holiday lets qualified as a business akin to a trade for inheritance tax purposes so that 100% business property relief could be granted in suitable cases. The current practice of HMRC Capital Taxes is now to deny business property relief in every case where the claim relates to a furnished holiday let. The denial of relief is on the basis that, although furnished holiday letting may be accepted as being a business activity, it is wholly or mainly the holding of an investment and thus business property relief is excluded. HMRC's current stance on this issue should be open to challenge in appropriate cases. The better view is thought to be that only businesses which are substantially of an investment nature are outside the scope of business property relief. This does not mean that a property must be used mainly for a trading activity in order to qualify for business property relief. There is an intermediate category of properties where the services provided as part of the lettings are significant enough to take the activity outside the investment category, thus qualifying for relief. An unreported case before the Special Commissioners in 1991 was won on this basis and, although the principle has not been revisited in more recent cases, the legislation itself has not changed and arguably the reasoning in the case still holds good.

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