Furnished Holiday Lettings

A Tax Guide

3rd edition

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6. Ownership structuring for a furnished holiday lettings business

6.1 Introduction

There are many tax and financing issues to consider on the acquisition of an FHL business. Many of these are not peculiar to holiday letting, and this chapter focuses on what might best be described as property business structuring.

Tax is not the sole driver and personal circumstances are very important. The structure must be right for the business owner. Tax does have a big impact though and the big increase in property taxes in the last few years does mean that thoughts on business structuring have altered considerably, with corporate ownership of property businesses having increased, rather than having decreased as the government expected.

Comparative tax rates are important. The corporation tax rate is much lower than the income tax rate and this is a key incentive to use a company owner where there is a desire to retain profits within the company – most likely to repay debt. It is therefore sensible to start by considering financing of the FHL business.

6.2 Financing

One of the key drivers of the ownership structuring is the method of financing of the purchase. It is common for FHLs to be purchased with debt finance, and interest costs can often be one of the largest items in the property income and expenditure account.

In accordance with the normal rules (as set out in the HMRC *Property Income Manual* at paragraph 2105) interest relief is available on borrowing costs up to the value of the property when it was first let. Where there is equity in a property, by reference to the value when it was first let, this can be released by means of a further loan advance and tax relief can be obtained on that additional interest cost (see HMRC *Business Income Manual* at paragraph 45700, Example 2). Conversely, if a loan draw-down is made against equity in a property, such that it takes the borrowings to a level in excess of the value of the property when it was first let and any

subsequent capital expenditure, the interest costs must be apportioned as between the qualifying and non-qualifying amount and any non-qualifying interest is disallowed.

It is therefore important to keep a record of the cost of the property when first let, which will not necessarily be the same as the cost of the property as far as capital gains tax is concerned. For instance, where a property has been used as a family holiday home and is subsequently brought into use in a property business, the relevant figure is the value at the time the property is first introduced into the property business.

Where there is owner occupation of a property, the interest expense may need adjustment for own use, in line with the normal rules for adjustments to property business expenses.

An interest restriction applies where residential property is let on a long-term basis under assured shorthold tenancies. This restriction prevents a full deduction of the interest charge and instead introduces a tax reducer set at the basic rate of income tax. It is designed to discourage buy to let mortgages but is instead simply encouraging incorporation as there is no restriction of interest expense as a deduction for corporation tax purposes as long as the annual interest expense is below £2m.

The interest restriction for higher rate taxpayers does not apply to FHLs. Many FHL business owners are basic rate taxpayers and so in any case are unaffected by this change. Despite these observations, this restriction of tax relief on borrowing costs does impact on FHLs in two ways:

- It is becoming commonplace to hold property assets in companies, unlike in the past when it was unusual except for very large portfolios; and
- Residential properties may change from being let on a long-term basis to being let as FHLs with the result that more FHLs will be let by corporates in future.

Law: ITTOIA 2005, s. 274A

6.3 Joint ownership with a spouse or civil partner

Where an FHL is acquired in personal names by a married couple, the most sensible ownership arrangement as far as income tax is

concerned is for the property to be owned jointly. This is because (unlike the position with ordinary property businesses) ITA 2007, s. 837(3) provides an exception to the normal rule that income must be apportioned equally between a married or civil partnership couple; instead, it can be allocated in whatever proportion the two owners choose. In this respect it is treated the same as a husband and wife trading partnership.

Joint ownership is a very flexible arrangement but there are other issues to consider. In particular, VAT will be relevant if there is an existing business making taxable supplies (see, generally, the *VAT Registration Handbook* from Claritax Books). It is therefore common, where there is another business activity, to have separate ownership of the FHL business in order to try to disaggregate the activities for VAT purposes (see **6.9**). This is often encountered with farms, bed and breakfasts and hotels. In these cases one activity may be carried on by one of the couple with another activity being carried on by the couple jointly. It is key to ensure that the separation is not seen to be artificial and HMRC may look at financial, economic and organisational links. It should be possible to overcome any challenge by ensuring that the indicators point to separate businesses, such as having separate bank accounts, ensuring invoices are addressed to the correct business, maintaining separate books and records, etc.

Depending on the age of the couple, and their personal circumstances, it may also be relevant to consider inheritance tax matters. Specifically in the case of a second marriage, there may be complex will provisions to prevent the property from passing to the survivor on the first death. Such cases would need careful discussion with the parties concerned.

IHT will be chargeable on a transfer of value by an individual of a UK FHL exceeding the available nil rate band and it should be noted that the spousal exemption is limited to the level of the nil rate band where the transfer is made to a non-domiciled individual. In such cases where the value of UK property exceeds the nil rate band, leading to an IHT charge, it is possible for a surviving spouse to opt in to the UK IHT regime and secure the spousal exemption. This should often be beneficial where the majority of the deceased's estate is UK sited.

Historically, joint ownership of an FHL by a married couple has been the most common approach. This will still probably be the case in future for largely retired owners with only one or two properties. In those cases, owning property jointly probably gives the best outcome. Also, where an FHL has been acquired alongside a family home then a married couple owning the property jointly makes sense and was probably also the best way to purchase the property from an SDLT perspective.

Some married couples may now purchase FHLs directly into a company owned jointly by them, although formally structuring the purchase by the husband and wife as a partnership rather than as joint ownership may be prudent from an SDLT perspective should the couple wish to incorporate in future.

6.4 Ownership by a partnership

FHLs can be owned as partnership property or as jointly owned property. The distinction may not be that obvious but there is a legal distinction in the nature of the ownership. Historically, this hasn't been that important but the SDLT rules using the sum of the lower proportions on incorporation has made the distinction very significant. These are the rules that apply on a change in the constitution of a partnership where there are related parties.

Where partners are related (such as husband and wife or their family) then their interest in the partnership is considered together. It is only where the partnership property moves outside of this related party grouping that SDLT is charged. A company owned by the related party group is included within the related party group and so is not subject to SDLT on a transfer of FHLs to it. If the FHLs were only jointly owned, and not within a partnership, then an SDLT charge would arise. Hence the impact of the existence of a partnership is financially very significant as far as SDLT is concerned.

For this reason ensuring that there is a partnership is very important and the advice to married couples is often to set up their ownership as a partnership at the outset in order to give maximum flexibility in future. Putting in place a partnership agreement, informing the bankers, having the right business stationery and

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