Furnished Holiday Lettings

A Tax Guide

4th edition

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Published by:

Claritax Books Ltd
6 Grosvenor Park Road
Chester, CH1 1QQ

www.claritaxbooks.com

ISBN: 978-1-908545-22-2

4. Capital expenditure

4.1 Introduction

Capital and revenue expenditure is likely to be incurred at different stages of property ownership, from acquisition through to ongoing general repairs and improvement or alteration of the property. The owner needs to retain accurate records of the expenditure so that the costs can be assessed for the purposes of capital allowances, revenue deductions and VAT throughout the period of ownership. Good records will also be required for a future disposal or transfer.

This chapter considers the main issues with property expenditure, focusing first on the qualifying VAT status to ensure that the contractor is applying the correct rate of VAT. It then looks at the distinction between capital and revenue expenditure and how this affects the deduction available through capital allowances.

Matters specific to the acquisition of FHLs are dealt with in **Chapter 5** (specifically SDLT and some VAT), and also **Chapter 6** on business structuring. This chapter should be considered alongside those later chapters.

4.2 VAT incurred on capital expenditure

Most owners letting holiday accommodation are not VAT registered as the income generated from the business is below the compulsory VAT registration limit (see **6.4**). VAT incurred is therefore a real business cost and it is important that it is considered at an early stage and that the owner works with a building contractor to try and minimise VAT as far as possible. There are a number of possible approaches to explore, albeit that often there is no easy or attractive solution.

The first approach is to ensure that the correct rate of VAT is being charged by a building contractor. Where a dwelling is being constructed then it may be that the building works can be zero-rated. VATA 1994, Sch. 8, Grp. 5, Item 2 states that the zero rate applies to "the supply in the course of construction of a building designed as a dwelling or number of dwellings".

Therefore, as long as the building satisfies the tests for a dwelling, zero rating applies. The building can meet the tests where it consists of self-contained living accommodation with no provision for direct access between dwellings and the use or disposal of a dwelling is not prohibited. The work must be lawful, with statutory planning consent granted and carried out in accordance with that consent. So it is imperative that the works are carried out in accordance with the planning consent for zero rating to apply. The definition of dwelling is considered in more detail in section **4.5** below.

If all conditions are met the contractor should zero rate supplies of services related to the physical construction of the building, including some work closely connected to the construction, for example demolition of an existing building, ground works, soft landscaping and snagging. Goods "incorporated" by a builder can also be zero rated if they are "building materials" as set out in VAT Notice 708 (sections 11.2 and 13). Services of an architect, surveyor or any person acting as a consultant will always be standard rated unless they form part of a design and build contract. The services will form part of a design and build contract if it is clear that they are "no more than cost components" of the overall supply (section 3.4.1 of VAT Notice 708). If it is clear that the cost is specifically supplied on to the customer then it will not be part of the design and build contract.

Indeed, even the self-build ("DIY") scheme can apply, as confirmed in the case of *Jennings* and in R&C Brief 29/10. The DIY refund scheme cannot apply where there is an intention for the construction of the dwelling to be in the course of furtherance of a business. In *Akester*, the DIY scheme refund was refused as the appellant could not demonstrate, on the balance of probabilities, that there was no intention to carry on a relevant business during the course of construction. In *Jennings*, the holiday home was constructed for a non-business purpose and the DIY scheme applied. The self-build scheme will generally only apply to construction of holiday accommodation for personal use.

Different rules apply if the property does not qualify as a dwelling, usually as a result of occupancy restrictions. The issue of occupancy restrictions was considered in *Barbara Ashworth*. The conclusion was that an occupancy restriction alone is not sufficient to turn a dwelling into holiday accommodation. The property must also amount to holiday accommodation on the facts in the first place.

Following the *Colaingrove* case, HMRC manuals were updated confirming their view "that the UK is entitled to distinguish between different types of property on the basis of permitted use". Where the occupier is prevented from residing in the property throughout the year the 'accommodation is to be treated as holiday accommodation regardless of how the property is held out'. Each situation will need to be assessed on its own facts.

The reduced rate of VAT of 5% is possible where there is a qualifying conversion or renovation of a building within VATA 1994, Sch. 7A, Grps. 6 and 7. This is most commonly encountered where former agricultural buildings are being converted into FHLs but can also apply where a dwelling has not been lived in for two years or where the conversion changes the number of dwellings. Reduced rating can apply to building materials and labour for services such as "repair, maintenance, or improvement".

The reduced rate of VAT of 5% could also apply where energy-saving materials are being installed within VATA 1994, Sch. 7A, Grp. 2. This could apply at rural properties where solar panels (and wind turbines or water turbines paid for before 1 October 2019) are being installed. The rules on these have been updated from 1 October 2019, limiting the scope of eligible expenditure. Expenditure qualified for the reduced rate where it was 1) a supply of services and 2) the materials installed by that person. The rules were tightened from 1 October 2019 so that expenditure qualifies for the reduced rate only if:

- one of the "social policy conditions" is met (i.e. supply to a relevant housing association, building used solely for a relevant residential purpose, qualifying person, etc.); or
- the new 60% threshold has not been exceeded.

The 60% test compares the cost of materials to the business with the total value of the supply. If the cost of materials is more than 60% of the amount charged to the client then the reduced rate will apply to the labour but the materials will be subject to standard rate. The new rules add further complexities in ensuring the contractor is charging the correct rate of VAT.

A different approach is for the FHL owner to register voluntarily for VAT so that the VAT incurred can be recovered. This can be attractive

where a substantial spend is incurred and particularly where the level of holiday letting may increase in future such that VAT registration will be required at some point. Alternatively, voluntary registration with future de-registration is possible and can be attractive although HMRC may seek to resist voluntary registration.

The capital goods scheme (CGS) should be considered if the FHL owner is registered for VAT and they are, or could potentially become, partially exempt. The CGS covers expenditure on land, buildings and civil engineering work exceeding £250,000, which could be appropriate for FHL owners; adjustments may be required to recovered input VAT over a 10-year period.

To combat "missing trader" fraud, HMRC have introduced a new reverse charge for the construction industry from 1 October 2020. The scheme will mean that only the supply to the end user will be charged VAT rather than a charge arising at each stage of the chain. It will only apply to specific services but generally we will see this where the CIS scheme applies. If the supply is zero rated or exempt the reverse charge will not apply, so there is plenty of scope for error.

It is important that VAT is fully explored at the outset, and a person may be required to provide evidence to the contractor that demonstrates that a lower rate of VAT applies. A building contractor may not be amenable to re-issuing invoices with a lower VAT rate once the works have been undertaken. If this is the case, the purchaser has unnecessarily incurred additional costs, which cannot be reclaimed as input VAT if the person is VAT registered.

Law: VATA 1994, Sch. 9, Grp 1, Note 11; VATA 1994, Sch. 8, Grp 5, Note 13
Cases: *Barbara Ashworth v C&EC* LON 94/221A; *Colaingrove Ltd v C & E Commrs* [2004] EWCA Civ 146; *Jennings v HMRC* [2010] UKFTT 49 (TC), [2011] UKFTT 298 (TC); *Akester v HMRC* [2018] UKFTT 542 (TC)

4.3 Is expenditure capital or revenue?

It is necessary to consider first the distinction between revenue and capital expenditure on properties used in FHL businesses.

As with similar trading activities involving the use of properties, the two cases of *Law Shipping* and *Odeon Associated Theatres* are extremely relevant. The key distinction was whether the asset was able to be used for the purposes of the activity at the time of acquisition. In the case of Odeon Cinemas, the company acquired "flea