

Furnished holiday lettings and Business Property Relief

Inheritance tax (IHT) Business Property Relief (BPR) is intended to enable businesses to survive a death uninterrupted and so protect the jobs and other economic benefits that flow from the business to the wider community. Since 1992 BPR has been available at a rate of 100% and so provides a complete (and generous) exemption from IHT.

BPR applies to business property (!)
The legislation at IHTA 1984, s.103(3) states that

“Business’ includes a business carried on in the exercise of a profession or vocation, that does not include a business carried out otherwise than for gain”.

The first requirement is that there must be a business and it must be carried on for gain. The requirement for the business to be carried on for gain should not be a problem for FHLs that satisfy the special income tax rules as there is a requirement that the lettings are commercial. So if the income tax requirements have been satisfied then that should deal with the requirement for a business to be carried on for gain. **However**, it is also necessary to consider whether a FHLs activity amounts to a “business” in the first place.

What is a ‘business’?

Whilst one would expect the definition of “business” to be well established, it is not as obvious as might first be expected. The recent tax appeal case of Elisabeth Moyne Ramsay has set out a general test as to what is a “business” for tax purposes.

A property letting activity - such as FHLs - must be a “serious undertaking earnestly pursued” and must:

- Have reasonable or recognisable continuity;
- Achieve a certain amount of

‘substance’ in terms of turnover;

- Be conducted in a regular manner on sound and recognised business principles; and
- Be of a kind commonly undertaken by those seeking to make a profit.

These tests need to be considered as a first stage as BPR cannot apply unless there is a “business”.

Limiting a ‘business’ for BPR – is it an investment activity

There is a further restriction included in the BPR legislation which states that

“A business or interest in a business, or shares in or securities of a company, are not relevant business property if the business consists wholly or mainly of making or holding investments”.

The restriction excludes certain types of business activities. However the excluded activities are not further defined within the legislation nor are there definitions of any of the terms used. As a result this sub-section is now the most litigated part of the inheritance tax legislation. It is important to appreciate that BPR is an all or nothing relief. So if one is considering a FHL property; it is either potentially liable to IHT at 40% or exempt from taxation.

Wholly or mainly

In the context of FHLs there are two phrases in s. 105(3) that need to be considered. First is the term ‘wholly or mainly’. This expression is used elsewhere within tax legislation and means ‘more than half’, so, 50% plus. But even this

apparently simple point has been argued before tax tribunals as recently as 2013.

Making or holding investments

Then there is the phrase, ‘making or holding investments’. If a business consists wholly or mainly of making or holding investments then it is not eligible for BPR. But ‘investments’ is not defined in the IHT legislation. Property letting is a business and so is potentially eligible for BPR **unless** it is a business consisting of the making or holding investments in which case BPR is not available. So, whether the business’s activity amounts to ‘making or holding investments’ is therefore crucial.

The holding of property as an investment is only one component of a property letting business, and if it is not the main component of an active business such a business should not be excluded from BPR, merely because a necessary component of its profit-making activity is the use of land.

The case law on this issue has established five criteria that need to be considered in deciding whether or not a business can qualify for BPR in this regard:

1. The time spent by the owners and staff employed;
2. The capital employed in the business;
3. The income of the business;
4. The profit made by the business; and
5. The overall context of the business.

The analysis of the criteria needs to be between what and how much of each

criteria is considered to be investment-related and what is non-investment-related.

The courts will ultimately examine the matter 'in the round', that is not looking, for example, just at the turnover or profit produced by the investment side of a business relative to the trading side. It may be possible to argue that the overall activities amount to a single non-investment business in totality, even if there is some investment business included in the mix.

HMRC's change of view

HMRC's Inheritance Tax Manual used to state at IHTM25278 that BPR would be allowed on even a single property used for FHLs provided that the lettings were short-term and that the owner (whether himself or through an agent) was substantially involved with the holiday makers in terms of their activities on and from the premises, even if the lettings were for part of the year only.

However, late in 2008, HMRC announced this was incorrect in law and amended their guidance. IHTM 25278 now states:

"In the past, we have thought that business property relief would normally be available where:

- the lettings were short term; and
- the owner, either himself or through an agent such as a relative, was substantially involved with the holiday makers in terms of their activities on and from the premises.

Recent advice from Solicitors' Office has caused us to reconsider our approach and it may well be that some cases that might have previously qualified should not have done so. In particular, we will be looking more closely at the level and type of services, rather than who provided them."

HMRC looked for a case to litigate on this issue following their change in stance and following the refusal of a claim for business property relief on the estate

of Mrs Pawson (deceased) a First-tier Tribunal case ensued (*HMRC v Lockyer & Robertson*).

Pawson

Mrs Pawson had died in June 2006, before HMRC changed their interpretation of business property relief. She had owned a quarter share in a holiday letting property.

Following the change in HMRC practice in late 2008, the claim for BPR on her share of the FHL business property was refused. The issue proceeded to the First-tier Tribunal which found in favour of the taxpayer. HMRC appealed to the Upper Tier Tribunal who found for HMRC. Leave to appeal to the Court of Appeal was denied and so the decision of the UT is now final.

Following the case, anyone seeking to claim BPR on FHLs need to be able to satisfy the requirements laid down in the judgement, which can appear to be overly stringent.

According to the UT the correct approach is to split the various activities of a business into those which are related to the use of the property, such as in the case of Pawson; maintenance, redecoration, and letting and leasing – these activities are 'investment' as they represent the exploitation of an asset; and those additional services which are non-land related, such as; cleaning, heating, hot water, television and telephone - these services do not relate specifically to land and are 'non-investment'. A business will only obtain BPR if the non-land related activities are "more significant" than the land-related activities. The term 'more significant' requires the exercise of considerable judgement as it could refer to 'more value' or 'more time spent'.

Zetland

Since *Pawson*, there has been a further case on this subject; heard by the First-tier Tribunal. This concerned the *David Zetland Settlement* which operated a large, commercially let property. The

crux of the case was whether the range and volume of the services provided by the owners of the property was such that the business consisted of more than just merely making and holding investments. The services included: hiring out conference rooms and a gallery for events; running a mail room; providing porters and 24 hour security; providing an internet service; providing a cleaning service; and hiring out bicycle stands – as well as letting commercial business units. It was noted that:

"The Tribunal must be mindful of the broad spectrum of businesses and the fine distinctions between different businesses. The better approach is for the Tribunal to have an open mind and not to pre-judge the issue at the start."

It is accepted in all the relevant case judgements that there is a 'spectrum'. The issue is where the boundary is between investment and non-investment businesses within that spectrum. The established test is what "an intelligent businessman" would think in making an assessment of this point – which begs the question of whether this would/should be a quantitative or qualitative test.

In *Zetland House* there was a gym, a café, and a hair salon but the taxpayer still lost. Probably because these were separate businesses and not operated by the trustees themselves.

This means that FHLs cannot rely on other businesses being carried on around them. The non-investment activity must be undertaken by the owner in order to be taken into account.

So, for FHLs three main criteria need to be considered:

- time spent (on management, delivery of services etc.
- income (allocated across the services); and
- overall impression (in the round).

For most FHLs it is likely that 'time spent' will mainly relate to non-investment activities. Whether the income mainly



PKF Francis Clark has eight offices in the South West: **Exeter, New Forest, Plymouth, Poole, Salisbury, Taunton, Torquay and Truro.** Please visit www.pkf-francisclark.co.uk for contact details of your nearest office.

PKF Francis Clark is a trading name of Francis Clark LLP. Francis Clark LLP is a limited liability partnership, registered in England and Wales with registered number OC349116. The registered office is Sigma House, Oak View Close, Edginswell Park, Torquay TQ2 7FF where a list of members is available for inspection and at www.pkf-francisclark.co.uk. The term "Partner" is used to refer to a member of Francis Clark LLP. Registered to carry on audit work in the UK and Ireland, regulated for a range of investment business activities and licensed to carry out reserved legal activity of non-contentious probate in England and Wales by the Institute of Chartered Accountants in England and Wales. Francis Clark LLP is a member firm of the PKF International Limited network of legally independent firms and does not accept responsibility or liability for the actions or inactions on the part of any other individual member firm or firms.

relates to investment or non-investment activities is therefore key. It does not matter how the income is described, it is the nature of what is being provided that matters.

This analysis is not necessarily straight forward, for example advertising to find new occupants might be regarded as related to a non-investment element of the business – however, in Pawson, the judge explicitly stated ‘the need to find new occupants’ is typically investment related.

How this relates to hotels and guest houses (that are normally regarded as at the non-investment end of the letting business) is not clear – but they certainly spend large amounts on advertising.

This allocation methodology means that FHLs are unlikely to achieve over 50% as being related to services.

So, where an FHL business is seeking to achieve BPR there must be a detailed quantitative and qualitative assessment showing that more than half of the business relates to non-investment activities – “guest services”. It is important that accounts and other information are prepared with this in mind. Such an assessment probably needs to be done over a time period of several years – some commentators suggest

5 years. So to maximise the chances of BPR relief; start collecting data, reformatting business processes (see below), services offered, and analysing now!

Reformatting business processes

Any business looking to achieve qualification for BPR should, as a minimum, provide a welcome pack/ hamper of food. However; it is not sufficient simply to buy in a ready-filled hamper (partly as the profit margin on a straightforward ‘re-sale’ to guests will be very low; and partly as it distances the proprietor from the service provided). Remember, in the financial analysis the provision of things like hampers must make a major contribution to the ‘services’ profit. The best approach would be for the hamper’s drinks & foods to be delivered to the FHL business, which then would make-up the hampers to put in each property. This would be something that would be done on every changeover.

Better still, would be the provision of some kind of café or bar facilities. Cafés or bar facilities are only likely to be economically viable where there are multiple letting units – so these suggestions need to be evaluated in the light of particular FHL businesses.

Consider the issue of linen, laundry and cleaning services generally; what may more traditionally be called ‘chambermaid services’. For business seeking to achieve qualification for business property relief this must be an ‘extra’ that is always offered. Where occupants are staying for longer than one week, there needs to be full servicing of the property at the end of each week. This is a key question that HMRC tend to ask about in every challenge to BPR for FHLs.

Many businesses will not wish to seek to provide such a high level of servicing of the properties during the holiday makers’ stay but where they do not then qualification for business property relief is unlikely.

John Endacott

Parts of this note are based the recently revised edition of John’s book: “Furnished Holiday Lettings: A Tax Guide”. Published by and available from Claritax Books (<http://www.claritaxbooks.com/>).

For information of users: This material is published for the information of clients. It provides only an overview of the regulations in force at the date of publication, and no action should be taken without consulting the detailed legislation or seeking professional advice. Therefore no responsibility for loss occasioned by any person acting or refraining from action as a result of the material can be accepted by the authors or the firm.

22/8/16_N



PKF Francis Clark has eight offices in the South West: **Exeter, New Forest, Plymouth, Poole, Salisbury, Taunton, Torquay and Truro.** Please visit www.pkf-francisclark.co.uk for contact details of your nearest office.

PKF Francis Clark is a trading name of Francis Clark LLP. Francis Clark LLP is a limited liability partnership, registered in England and Wales with registered number OC349116. The registered office is Sigma House, Oak View Close, Edginswell Park, Torquay TQ2 7FF where a list of members is available for inspection and at www.pkf-francisclark.co.uk. The term ‘Partner’ is used to refer to a member of Francis Clark LLP. Registered to carry on audit work in the UK and Ireland, regulated for a range of investment business activities and licensed to carry out reserved legal activity of non-contentious probate in England and Wales by the Institute of Chartered Accountants in England and Wales. Francis Clark LLP is a member firm of the PKF International Limited network of legally independent firms and does not accept responsibility or liability for the actions or inactions on the part of any other individual member firm or firms.