THE TAX TREATMENT OF RESIDENTIAL PROPERTY

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1. CGT private residence relief

Principal private residence relief is set out in s. 222 TCGA 1992: This provides for a total relief from CGT on gains made between acquisition and sale of qualifying residential property. It should be noted that the relief is not limited to homes in the UK.

Where a person owns one or more properties that have been his/her main residence he/she is entitled to relief on the final period of ownership even if he/she has not been living in it immediately before it is sold.

1.1 Reduction in "period of final ownership"

This "period of final ownership" used to be 36 months but was amended by Finance Act
2014 to 18 months. This was effected by an amendment to s. 223 TCGA 1992.

This has had effect where contracts for the sale of the property are exchanged on or after 6 April 2014.

According to the Treasury, the reason for this was: to "*reduce the incentive for those with multiple homes to exploit the rules*".

1.2 Exemption from reduced time limit

Exemption from this change provided for in new section 225E for people who are disabled or have moved into residential care homes on a long term basis (at least 3 months). For these people the final period will remain 36 months. The

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definition of disabled person is the one which now applies across a number of taxes and is set out in FA 2005 Sched 1A. Note that it is necessary to be "in receipt" of an allowance, not merely eligible for it. There are detailed conditions, in particular for a claim under the section by a disabled person the property concerned must be the only residence available to that person and his or her spouse.

According to the Treasury, this was "*in recognition that a person may take longer to decide of their former home*" under those circumstances. In my view this reasoning is somewhat dubious.

1.3 Cases on principal private residence relief

An increasing number of principal private residence claims are being challenged by HMRC in the Tribunal.

1.3.1 What constitutes a residence?

Because the election procedure for which of two residences remains the primary residence (as to the proposed amendment of this, see below) is conclusive under the current legislation, the key question which arises in these cases is what constitutes a "residence" at all.

In *Moore v HMRC* [2010] UKFTT 445 (TC), house was bought as a prospective family home and a man moved in to renovate it. However, his fiancée disliked it – in the words of the judge "would not countenance living there". It was held not to be the taxpayer's residence, as the taxpayer was always fully committed to his relationship. In *Moore*, Judge John Walters QC helpfully summarises the earlier authorities in relation to the issue of 'residence' as follows:

> "A residence for these purposes must be a person's 'home' (*Sansom v Peay* 52 TC 1 at 6G), 'a place where somebody lives' (*Frost v Feltham* 55 TC 10 at 13I). However, 'even occasional and short residence in a place can make that [place] a residence' (*Moore v Thompson* 61 TC 15 at 24E).
>
> [In] *Goodwin v Curtis* 70 TC 478...the Court of Appeal ... was unanimous in the view that 'there must be some assumption of permanence, some degree of continuity, some expectation of continuity to turn mere occupation into residence' (ibid. at 508I, 510H)."

The decision in *Moore* is quite harsh: the man and his fiancée did not live together at the time. The man did reside in the house; he just did not intend to do so for very long.

Intention is viewed as an important factor.

1.3.2 Taxpayer losses

In *Benford v HMRC* [2011] UKFTT 457 (TC), the taxpayer went through a very short marital separation, when he bought a house in bad disrepair. He sold it and moved back in with his wife. There were electricity bills showing very little usage. It was held that this house never became his residence. of the question of intention arose: did the parties intend to live separately? There was a more difficult, factual question as to whether, other than the odd night during the renovation work, he ever lived there at all.

In *Michael J Harte and Brenda A Harte v HMRC* [2012]., a married couple made an election and moved into the property for just eight days, whilst deciding whether to live in it permanently. The Tribunal found that this was not their residence as they never formed an intention to live there permanently.

In *Bradley v HMRC* [2013] UKFTT 131 (TC), the taxpayer owned several properties. Her husband lived in one, and she moved into another, which she sold sometime later. Held not to have been her residence, it being noted that she had advertised the house for sale before moving into it. If it hadn't been for this, there should have been no reason why the fact they lived apart would have stopped this property from being the wife's residence. (Of course they would have had to share a main residence election, so they could not have benefitted simultaneously from both – but could have elected a main residence again after the sale.)

In *P Moore v HMRC* [2013] UKFTT 433 (TC)., the taxpayer bought a house, and rented it out. He moved into it some years later, when he left his wife. However, when he left the marital home, he arranged for his post to be forwarded to the house of his new partner. He lived in the house for a matter of weeks. It was held that it never became his residence at all. The judgment does not record in much detail why the delivery of the post was so decisive a factor in this case: was this evidence of intention? A significant factor is the relatively short time he spent in the house, with sufficient explanation for a short period of residence, this need not be decisive.

In *Gibson v HMRC* [2013] UKFTT 636 (TC), the Tribunal addressed the question of the rebuilding of a house. It accepted that the question of when one dwelling house stops being that house and becomes another, because of significant alteration, is a question of degree. In this case, the house was entirely demolished and another house built in its place. The taxpayer lived in the first but not in the second. The Tribunal took into account the fact that none of the materials from the old house were reused. The judge with the casting vote held it was not the same dwelling house and so not the same residence. HMRC also argued that the two houses were so different in layout that they were not the same dwelling. The First Tier Tax Tribunal rejected this. It is possible to entirely alter the internal layout without altering the dwelling itself.

1.3.3 Taxpayer victories

In *Clarke v HMRC* [2011] UKFTT 619 (TC), after his divorce, the taxpayer took a development loan from a bank to finance the acquisition of a property, which he said to the bank would be developed and sold. He claimed that it was his main residence during renovation. The taxpayer explained to the First Tier Tax Tribunal that his loan application was made to secure quick funding and that he in fact inhabited the property for some months, until his wife went away and he then moved back to marital home. It was held to have been a residence. This judgment sensibly accepts the distinction between a property not being a residence at all, and a property not being a residence for very long.

In *D Morgan v HMRC* [2013] UKFTT 181 (TC), a man lived in a property for six months out of seven years of ownership, due to complicated personal circumstances. However, when he moved in he had the intention to make it his home and unconnected factors intervened. It was held to have been his residence. It was not sufficient for HMRC to rely on fact that he had very basic furniture.

1.3.4 Lessons

The question of whether a property is a residence is fact specific, hence the taxpayer should retain documents, e.g. utility bills. The length of occupation indicative but not decisive provided there is a reasonable explanation for short periods; intention is given considerable weight. Renovations are permitted but it is a question of degree.

1.3.5 Election is conclusive

In *Ellis and another v Revenue and Customs Commissioners* [2013] SFTD 144, the taxpayer had elected for one of his properties to be treated as his main residence for CGT purposes. HMRC first attempted to argue that a house was not a “residence”, but later accepted that this argument was, on the facts, impossible to make out.

They changed tack and, at the hearing, HMRC then contended that the property was not a “main residence”. HMRC argued that the Tribunal should have regard to: the comparative amount of time spent at each of the two residences, the nature and quality of the use made of each residence and the fact that a second residence, a house in Slough, was also used by the taxpayers when two of their granddaughters resided with them, often for significant periods of time, for family reasons. The point is, of course, irrelevant – HMRC should never have taken it. The Tribunal pointed out:

> *The important point to note about the construction of s 222 TCGA is that once it is established (or accepted) that a taxpayer has more than one property that can properly be called his residence, it is the taxpayer who can make an election as to which of two or more residences is to be his main residence. It is equally important to note that sub-s 5 of s 222 specifically provides that 'the individual may conclude that question by notice to an officer of the Board …' and that this is a case in which such notice was given... In other words, the respondents can challenge the assertion made by a taxpayer that a particular property is a residence used/occupied by him, but once it is proved or accepted that a particular property is a residence used/occupied by the taxpayer, the respondents cannot argue that as a matter of fact and degree that residence is not the taxpayer's main residence if an election has been made in favour of that property under s 222(5).*

1.4 Consultation to end main residence elections

A Consultative Document was issued on 28 Match 2014 entitled "Implementing a capital gains tax charge on non-residents".

We are (at time of writing) awaiting the next stage, i.e. the government's response to the responses to the con. doc., due "in early Autumn 2014."

One proposal contained in the Consultative Document is to abolish the election procedure for principle private residence relief:

> *3.3 Bringing non-residents into CGT without any changes could mean that non-residents invariably chose to nominate their UK residence as their main residence and obtain tax relief on gains made on that property, even where it was not in fact their main residence, yet not pay any UK CGT on gains relating to their other residences outside of the UK. This would undermine the extension of CGT to non-residents.*
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> *3.4 With this in mind, the government is considering changing the election rules. In line with the current PRR process, taxpayers may be asked by HMRC to demonstrate their entitlement to relief and so may need to keep records for this purpose. UK residents are already required to show, when asked by HMRC, that a residential*

> *property that they have disposed of qualifies for PRR, including that it was in fact used as their main residence or, if they have made an election, as a residence by them for the period covered by the election.*

In other words, this would be a test of "fact and degree" such as HMRC erroneously tried to impose in *Ellis*.

The consultative document then went on to suggest two possible ways in which the election might be altered:

1. *Remove the ability for a person to elect which residence is their main residence for PRR. This would mean that PRR would be limited to that property which is demonstrably the person's main residence. The government envisages that this would build on the existing process that applies where an individual with two or more residences has not made an election. In these cases, the person's main residence is determined by the balance of all the evidence including factors such as the address where the taxpayer's spouse or family lives, mail is sent, and that is on the electoral roll.*
2. *Replace the ability to elect with a fixed rule that identifies a person's main residence e.g. that in which the person has been present the most for any given tax year. Depending on the test that is devised this may mean that taxpayers have to keep different or additional records.*

The three potential indicia they mention in the context of the first suggestion appear reasonable at first sight, but of course they can be far from determinative. The question of where a family lives makes some sense, but it would be absurd to say that alone is proof of someone's principal residence. In so many cases it simply will not be so. This might be an indicator of whether a place is a residence at all, but not whether it is the principal residence of a particular taxpayer. Where a person is on the electoral role is easy enough to change at the behest of a tax advisor. If that is not sufficient to rule it out as a sensible factor, the fact that many people remain – particularly in non-general election years – on an out of date electoral roll, might be. Similarly to the location of a family, where mail is sent might be in indication of whether something is a residence (see *P Moore v HMRC discussed above*) but there might be all sorts of reasons other than principal residence to choose one location rather than another. Perhaps mail in London is sent to work, but in the country cannot be. Other than utility bills it is not unusual to get very little post nowadays. What is more, it would be easy enough to manipulate this factor if u one wants to.

If these are meant to be representative of the sorts of thing HMRC will consider, rather than the only ones, it is interesting that HMRC is considering introducing such uncertainty into the tax system

It is also going to impose burden on people who may need to demonstrate that a particular home is their principal private residence. Record keeping, unless done deliberately with the taxman in mind, is unlikely to be very good.

The second potential test could be quite misleading; also very difficult to expect people to have kept records of which of their houses they have spent more nights at; or more days at.

Might it be sensible to take this second suggestion and tweak it, so that taxpayers retain the right to elect which of their homes is their principle private residence provided that they pass a sufficient day test at the home they want to nominate. Say, if they spend a minimum of 50 nights a year at a property, then they can nominate it?

2. CGT relief on properties occupied by relatives

Section 226 TCGA 1992 provides for an essentially defunct relief from CGT on the disposal of properties occupied until 5 April 1988 by a "dependent relative". The definition of "dependent relative" is:

> *(6) In this section "dependent relative" means, in relation to an individual—*
>
> *(a) any relative of his or of his wife who is incapacitated by old age or infirmity from maintaining himself, or*
>
> *(b) his or his wife's mother who, whether or not incapacitated, is either widowed, or living apart from her husband, or a single woman in consequence of dissolution or annulment of marriage.*

However it is still possible to obtain relief on properties occupied by relatives/others reasonably simply with the use of a trust.

For example: a thinly capitalised life interest trust can be created with the relative, or other intended beneficiary, as the life tenant. The trust should be drafted to allow the trustees to permit the beneficiary to occupy properties owned by the trust. The purchase price of the property can then be lent by the benefactor to the trust, which can use the loaned money to purchase the property. The loan of the money to the trust will not incur a charge inheritance tax; and the property will belong to the trust, and so section 225 TCGA 1992 will apply to allow relief as the main residence of a person entitled to occupy it under the terms of the settlement.

There is a risk of section 73(1)(b) TCGA applying to deem a reversion to the disponor to be at no gain/no loss (subject to section 73(2A) TCGA. The trust will need to be drafted with this in mind, so that it does not come to an end on the death of the life tenant.

3 Extension of CGT to non-residents

Section 2(1) TCGA provides: "Subject to any exceptions provided by this Act, and without prejudice to sections 10 and 276, a person shall be chargeable to capital gains tax in respect of chargeable gains accruing to him in a year of assessment if the residence condition is met."

"The residence condition" is defined in s.2(1A) TCGA and broadly restricts liability on individuals, trustees and personal representatives to those who UK resident for CGT purposes.:

The consultative document now says:

> *The government does not believe that it is right that UK residents pay capital gains tax when they sell a home that is not their primary residence, while non-residents do not. Similarly, we do not believe that it is right that UK companies are subject to tax on gains that they make from disposals of residential property, whereas non- residents are not. It is important for the integrity of our tax system that when gains are made from UK residential property, UK tax is paid*

This policy aim is dealt with as follows in the document., which limits it to residential property:

> *2.3 The government intends to focus the extended CGT charge on property used or suitable for use as a dwelling i.e. a place that currently is, or has the potential to be, used as a residence. This will include property that is in the process of being constructed or adapted for such use, in line with the definition in the ATED regime (although, where residential property is developed as part of a business, normal considerations will first be given as to whether any gains should be properly taxed to income or profit, rather than to CGT). The government does not intend to change the tax treatment for property, such as office and industrial*

buildings, which cannot be used as and are not in the course of being converted to a place to live.

> *2.4 However, it would not be right to exclude all disposals of property used for commercial purposes, for example residential property used to generate income from letting. UK residents pay CGT when they sell a home that is not their main residence, including residential property that they have bought for rental purposes. The government believes that it would be unfair to charge CGT on residential property disposed of by a UK person who has the property as a second home, and not to do likewise when an equivalent residential property is disposed of by a non-resident landlord. The government also believes that gains made on disposals of residential property used as an investment should be subject to CGT.*

This therefore differs from the provisions for the Annual Tax on Enveloped Dwellings (ATED).

3.1 Specifics

Non-resident trustees are included:

> *2.10 ...To ensure comparable treatment between trustees that are regarded as UK resident and those that are not, the government believes that trustees that are not regarded as UK resident should be subject to CGT on the gains that they make on disposals of UK residential property. If they were not included in the scope of the charge, this would create tax avoidance opportunities.*

Non-resident partners are included:

> *2.9... Property owned by partnerships is transparent for tax purposes. This means that any chargeable gain on the disposal of the property results in a CGT charge on each UK resident partner individually, reflecting the extent that they are entitled to those gains. The government believes that this approach for apportioning partnership chargeable gains should stay in place, so non-resident persons who are partners will be taxable under the new CGT regime to the extent that gains are attributable to them.*

Non-resident companies are included:

> *2.27... The government believes that with no further changes to the CGT*

> *regime, individuals may be incentivised to set up companies to hold lower value residential property to avoid the new CGT charge. Therefore the government is minded to extend CGT to all UK residential property sold by non-resident corporate envelopes, so that all properties are within scope, including those valued below £500,000. However, the government will ensure that the ATED-related CGT charge only applies to those properties that are also subject to the ATED-charges each year.*

Non-resident individuals investing in collective investment schemes, which own UK residential property, will not be subject to the new charge, unless the collective investment scheme is regarded as "close" under a proposed new test:

When a UK Real Estate Investment Trust disposes of a property, it is not subject to CGT; nor will non-UK Real Estate Investment Trusts. When a UK resident individual disposes of shares in a Real Estate Investment Trust, he is liable to CGT but as the disposal is of shares and not of UK residential property, there is no proposal to extend this to non-UK resident investors.

3.2 Exclusions

There are three proposed exclusions:

- *accommodation for children and students: use as a home or other institution providing residential accommodation for children; residential accommodation for school pupils; or as a hall of residence for students in further or higher education*
- *accommodation to provide care: use as a home or other institution providing residential accommodation with personal care for persons in need of personal care and nursing by reason of old age, disablement, past or present dependence on alcohol or drugs or past or present mental disorder; a hospital or hospice*
- *other communal accommodation: use as communal residential accommodation for members of the armed forces; other institutions that are the sole or main residence of at least 90% of its residents; and prisons or similar establishments*

3.3 The annual exempt amount

The annual exempt amount will be available to non-UK residents who are liable to CGT at the same level as it is available to UK residents (2014/5 £11,000).

3.4 Rates of CGT

The rate of CGT for non-resident individuals will be 18% or 28%, as for UK residents, with the appropriate rate determined by the value of their UK income and gains in the relevant year. There will be a mechanism for allowable losses to be determined.

For companies (UK resident companies would expect to pay Corporation Tax), the situation is more complicated and a solution is awaited:

> *2.30 The government appreciates that some ways of ensuring that non-resident companies making gains from disposals of UK residential property are subject to UK tax may be more complex than others. The government could make disposals of UK residential property subject to a UK CGT charge, but this could lead to a higher tax charge than UK resident companies within the UK corporation tax regime that have access to allowances and reliefs. The government could also bring non-resident companies into UK corporation tax, but access to different allowances and reliefs could be costly and undermine the corporation tax regime which offers those reliefs to companies with permanent establishment in the UK. The government does not intend to make any changes that would have undesirable consequences on UK companies already in scope of the UK tax system.*
>
> *2.31 On balance, the government is minded to introduce a tailored approach within CGT or corporation tax to charge gains made on disposals of UK residential property by non-resident companies. This approach would place a charge only on gains made on disposals of UK residential property by non-resident companies. If this approach is introduced, the government intends to allow losses that non-resident companies incur on disposals of UK properties only.*
>
> *2.32 In combination with the ATED-CGT charge this means that: corporate envelopes that are not genuine businesses disposing of UK residential property will be subject to the ATED-related CGT charge at 28%; and other companies disposing of UK residential property will be subject to the tailored charge. The government will confirm the rate of tax charged on disposals of UK residential property by non-resident companies at a later date.*

3.5 Collection

How will the new tax be collected from non-residents? Possibly withholding tax, details to follow:

> *3.15 The government is minded to introduce a new process for the reporting and payment of CGT by non- residents who dispose of UK residential property. The government's preference is to introduce a form of withholding tax that operates alongside an option to self-report the tax due.*
>
> *3.16 The operation of the withholding tax could work as follows. The initial stage would be the identification that the seller of a residential property is a non-resident. The non-resident may then have an option to pay a withholding tax or to pay the actual tax due. There would then need to be some transfer of monies and reporting of the tax paid, to allow for any differences to be settled with HMRC. The government believes that it may be possible to do this in a similar way to the existing SDLT process, with agents transferring monies due within 30 days.*

Since there is no similar mechanism for UK taxpayers this would introduce an element of inequality with UK tax payers? It would also introduce an administrative burden on conveyancing solicitors?

3.6 Treaty relief

Under article 13 OECD Model Treaty, the UK is entitled to tax the disposal of land in the
UK. There is therefore no treaty relief when treaties follow the OECD model.

4. The extension of ATED

4.1 Reduction of threshold from properties valued at £2m to properties valued at £1m.

The Annual Tax on Enveloped Dwellings is currently imposed on residential property which is worth more than £2m and is held in a company or other non-natural person.

Rather than prompting large numbers of people to unwind the structures that fall within the ATED charge, this has been raising substantial revenues as people have opted to pay the annual charge.

In each case it is a question of balancing IHT benefits of retaining corporate structure; costs of unwinding, including charge to CGT; and cost/cash-flow of paying the ATED. ATED is now being extended with effect from 1 April 2015. Section 99 FA 2013 was amended by section 109 Finance Act 2014 so that for enveloped properties in a new more than £1m to £2m band, the annual tax is £7,000.

The valuation date is still 1 April 2012, or if later when a property is bought or sold. The next valuation date will be 2017.

In a linked measure: on 6 April 2015 the CGT charge on selling property with ATED- related gains will be extended and there will be rebasing to that date/.

The tax payable on enveloped dwellings is linked to the Consumer Price Index:

Chargeable amounts for chargeable period 1 April 2014 to 31 March 2015

Property Value	Annual Chargeable Amount 2014 to 15
More than £2m but not more than £5m	£15,400
More than £5m but not more than £10m	£35,900
More than £10m but not more than £20m	£71,850
More than £20m	£143,750

People affected by the new band will have until 1 October 2015 to file their first ATED return and until 31 October 2015 to pay the charge.

Thereafter the usual ATED filing and return date of 30 April will be effective.

4.2 Reduction of threshold from properties value at £1m to properties valued at £500,000

From 1 April 2016 there will be a further new band introduced. Properties valued at more than £500,000 but not more than £1m will be subject to an annual tax of £3,500.

On 6 April 2016 the CGT charge on selling property with ATED-related gains will be extended. There will be rebasing to that date.

There is time to unwind properties worth between £500,000 and £2m from holding structures that would cause them to fall within ATED. It is therefore time to review the advantages and disadvantages of retaining the structure.

Remember the ATED exclusions:

property rental businesses (sections 133 to 136);

property development businesses (sections 138 to 140);

property trading businesses (sections 141 to 142);

properties open to the public at least 28 days a year and run as a business (section 137);

employee or partner accommodation, provided the occupier is not too closely connected with the company/partnership and broadly, owns less than a 10% share in the business (sections 145 to 147);

farmhouses occupied by a working farmer (sections 148 and 149);

financial institutions acquiring dwellings in the course of lending (sections 143 and 44);

providers of social housing (section 150).

5. SDLT extension

The 15% flat rate SDLT charge on acquisition of "high value" enveloped dwellings is extended by redefining "high value" from £2m to £500,000 from 20 March 2014.

(Section 111 FA 2014).

6. IHT

"Enveloping" is still an option for non-UK domiciliaries (also deemed), who are prepared to pay the ATED.

An alternative inheritance tax relief is provided by s. 102B FA 1986 for co-habitation cases. A gift of a share in a property may be given to family members, eg children as a potentially exempt transfer. Section 102B(4) provides that there is no gift with reservation of benefit if:

(a) the donor and the donee occupy the land); and

(b) *the donor does not receive any benefit, other than a negligible one, which is provided by or at the expense of the donee for some reason connected with the gift.*

Occupation is required, but not necessarily as a family home. The gift will of course be a disposal for capital gains tax purposes. The donor must not receive linked benefits, but there is no requirement for proportionate sharing of expenses. There is also no reference to full consideration as the basis for the provision; hence the donor may give more than a 50% interest. The relief will cease to apply, and so the reservation of benefit will start if the cohabiting donee ceases to occupy the property.