DEVELOPING A TAX PROBLEM – IDENTIFYING A PITFALL WITH THE CAPITAL GAINS TAX RELIEF FOR PRIVATE RESIDENCES

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Background

The capital gains tax 'private residence' relief is well known, by tax practitioners and taxpayers alike. It serves to exempt from tax any gain arising on the disposal of a taxpayer's only or main residence, with (potentially) reduced reliefs in cases where the residence disposed of had not been the taxpayer's only or main residence throughout the period of ownership.[2]

The exemption has existed for as long as capital gains tax[3] and has not substantially changed. Consequently, there have been few legislative updates to reflect lifestyle changes over the past four decades. This article focuses on one area where there is a lacuna in the legislation leaving taxpayers exposed to a potentially unexpected tax liability.

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2 Taxation of Chargeable Gains Act 1992, sections 222(1) and 223. The statutory test refers to a taxpayer's "only or main residence" but the bailiwick of sections are known as the "private residence" rules. The common name for the exemption, "principal private residence relief" is strictly inaccurate.

3 the original provisions being found in section 29 of the Finance Act 1965

The scope of the exemption

The main exemption for private residences is provided for by section 223 of the Taxation of Chargeable Gains Act 1992. That section considers two mutually exclusive scenarios: one where the dwelling house (or part of the dwelling house) in question was the individual's only or main residence throughout the period of ownership[4] (or for all of the period of ownership except for all or part of the last three years of that period), the second where the dwelling house was the only or main residence of the individual for some lesser period.

In both cases, section 223 is dependent on the application of the preceding section, section 222, which in turn focuses on the taxpayer satisfying the conditions set out in subsection (1). That subsection reads as follows:

> "This section applies to a gain accruing to an individual so far as attributable to the disposal of, or of an interest in–
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> (a) a dwelling-house or part of a dwelling-house which is, or has at any time in his period of ownership been, his only or main residence, or
>
> (b) land which he has for his own occupation and enjoyment with that residence as its garden or grounds up to the permitted area."

Superficially, section 222(1) is drafted so as to ensure that the exemption covers both the house and garden. However, as is common with provisions that have a superficial simplicity, pitfalls can lie therein.

House and garden

Paragraph (a) of subsection (1) causes no immediate difficulties. It provides that the exemption is available in respect of the disposal of a dwelling house (or part of a dwelling house or an interest in either a dwelling house or part thereof). The fundamental condition that needs to be satisfied is that, at some time in the individual's period of ownership[5], the dwelling house has been the individual's only or main residence.

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4 defined, for these circumstances, to be restricted to the period of ownership on or after 31st March 1982 (section 223(7)

5 not restricted to only the period of ownership on or after 31st March 1982

The difficulty lies with paragraph (b). Whilst paragraph (b) was intended to extend the scope of the exemption to cover the garden or grounds belonging to the residence[6], the wording of the paragraph can actually limit the availability of the relief.

It is relatively well known that the use of the present tense in paragraph (b) and the requirement for the land to be occupied and enjoyed with *that* residence [i.e. that residence referred to in paragraph (a) which is (or has been) the individual's only or main residence] will give a taxpayer difficulties in cases where the grounds are fenced off before being sold, perhaps to a developer. See Example 1.

> ***Example 1***
>
> Dave has owned a house with a garden (within the permitted area) since 2000. The house has represented Dave's only residence throughout this period.
>
> In order to raise funds, Dave fences off part of his garden and sells a plot of land to a developer.
>
> Following the decision in *Varty v Lynes*[7], HM Revenue and Customs will deny any relief in respect of the disposal of the land to the developer.

The facts of *Varty v Lynes* were different from those in Example 1. In *Lynes*, the taxpayer had sold the house and some of the garden in 1971 and then the remainder of the garden in 1972 (by which time it had the benefit of outline planning permission). The 1972 disposal was of land which, by the date of the disposal, was no longer for the taxpayer's occupation and enjoyment with his only or main residence. Consequently, any gain arising thereon was not attributable to the disposal of land within the terms of what is now section 222(1).

Similarly, in the case of Example 1. Whilst the house might not have been disposed of when the plot is sold (and indeed, the house might well continue to be the taxpayer's only or main residence), subject to the actual facts of the case, the fencing off of the land might mean that it has ceased to be enjoyed with the residence. If so, relief will not be available on the disposal of the land.

It should go without saying that the installation of a fence *per se* should not preclude relief. It, as is usually the case, depends on the particular facts. However, the HMRC view is that fencing off the land will give rise to a loss of

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6 up to the permitted area

7 (1976) 51 TC 419

relief[8] and therefore it is advisable for taxpayers to avoid doing this if at all possible.

An alternative trap

A less common difficulty can arise in a situation in which a taxpayer sells two houses, which the taxpayer has occupied consecutively as his/her only or main residence.

Ordinarily, one would think that if a taxpayer owns a house, lives in it as his/her only or main residence, sells it and lives in another, the second house on its subsequent disposal would qualify for full private residence relief. However, care needs to be taken in respect of the period of ownership of the second home.

For example, relief will be restricted if the second home had been owned for a considerable period before it became the taxpayer's only or main residence. However, there can be a situation in which the second home was occupied as the taxpayer's only or new residence as soon as it was constructed.

This conclusion would not be surprising if one realised that the second home were erected on land that had previously been owned by the taxpayer – as this would be similar to the situation in which the home had been previously owned but not occupied as the taxpayer's only or main residence.[9] This was the situation in the recent *Henke* case.[10]

However, the conclusion holds even if the land would have previously qualified for exemption. See Example 2.

> ***Example 2***
>
> Jack buys a house with a garden within the permitted area. He lives in the house for five years – the house representing his only residence.
>
> Jack then obtains planning permission and builds a new house at the bottom of his garden. When it is complete, he moves into the new house

8 See, Capital Gains Manual, paragraph 64363.

9 This presupposes that the opening words of section 222(7) provide that the period of ownership commences upon the first acquisition of an interest in the land rather than simply when the land first becomes the only or main residence.

10 *Henke and Anor v R & C Commrs* (2006) Sp C 550

and sells the old house and some of the garden – retaining ownership of the new house and part of the garden.

Five years later, Jack sells the second house and relocates to another part of the country.

Ignoring the period of construction, the land on which the second house was built has, throughout the period of ownership, represented either:

- originally, land which Jack has had for his own occupation and enjoyment with his only or main residence as its garden or

- latterly, Jack's actual dwelling house which is his only or main residence.

However, in respect of the first five years, that is not sufficient to exempt fully Jack's gain.

Instead, Jack will be liable to capital gains tax in respect of this earlier period. This is because section 223 focuses on the time for which the *dwelling house* has been the taxpayer's only or main residence during the period of ownership. Whilst the land sold after ten years includes Jack's dwelling house, that dwelling house was Jack's only or main residence for only five of the ten years in the period of ownership. Consequently, the full exemption in section 223(1) cannot apply and, instead, only the partial exemption given by section 223(2) applies.

Jack is also unable to benefit from any relaxation given by section 223(3) (as extended by extra-statutory concessions and practices) because there was no 'period of absence' before which the land constituted a dwelling house which was Jack's only or main residence.

Therefore, Jack must account for half of the capital gain arising.

Resetting the clock

The simplest way to circumvent this anomaly would be to reset the 'period of ownership' clock so that this critical period is limited to the time in which the dwelling house on the land is actually the taxpayer's only or main residence.

Since 10th December 2003, it has no longer been possible to transfer a property into a settlor-interested trust with the benefit of a claim under section 260 of the Taxation of Chargeable Gains Act 1992[11].

In the case of a taxpayer who is married (or a member of a civil partnership), a transfer of property from one to the other should not give rise to any immediate capital gains tax consequences[12].

When dealing with the interaction of this rule and the private residence rules, however, care needs to be taken of section 222(7)(a). That curious provision extends the definition of the period of ownership so that the transferee spouse (or civil partner) inherits the acquisition date of the transferor spouse (or civil partner) – in much the same way as the taper relief rules operate[13].

The apparent purpose of section 222(7)(a) is to ensure that the exemption for private residences is not skewed by inter-spouse transfers. Without that provision, the relief could be enhanced or severely diminished, depending on the facts of the case. However, section 222(7)(a) is very narrowly drafted. Consequently, it is a provision that can be employed gainfully when it is of benefit to a couple (for example, when the property was their only or main residence for a considerable period before the [proposed] transfer). Similarly, it is a provision that can be easily side-stepped when it would be detrimental to the couple (for example, when the property was not the main residence for much of the transferor spouse or civil partner's actual period of ownership). See Example 3.

Example 3

Continuing with the facts of Example 2. Suppose also that Jack is married to Jill. If he transfers to Jill beneficial ownership of a residence whilst it is treated as their only or main residence, section 222(7)(a) ensures that the private residence relief operates as if Jack's period of ownership were Jill's.

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11 section 169B. Even if the trust were not settlor-interested, private residence relief is now precluded from being available to trustees if the trust acquired the residence subject to a holdover relief claim under section 260 (section 226A).

12 principally under section 58

13 See Schedule A1, paragraph 15.

However, if Jack were to transfer ownership of the second house *before* the couple moves into it, section 222(7)(a) cannot apply[14]. Consequently, Jill acquires the property with no 'history' (other than her husband's base cost and period of ownership for taper relief purposes).

Therefore, if Jill then sells the house after five years, the only taint on the relief will be in respect of the period between the transfer and the couple's moving in. If planned well, the resulting chargeable gain could be *de minimis*.

Summary

It can be seen, therefore, that common practices with regard to residences can give rise to unusual capital gains tax results – mainly because of the legislation not catching up with modern life. Equally, however, the vintage of the legislation ensures that, with some care (and non-provocative) planning, taxpayers can usually avoid or minimise the tax downsides.

14 because the statutory requirement is that there has to be a disposal of an interest in a dwelling house which *is* the couple's only or main residence. In the example, the transfer is likely to take place before the dwelling house has even been built and should definitely occur before the house becomes the couple's only or main residence.