The Personal Tax Planning Review

THE MAIN RESIDENCE EXEMPTION FROM CAPITAL GAINS TAX: INTER SPOUSE DISPOSALS

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One of the few remaining fiscal arguments for co-habiting without getting married is that under s.222(6)(a) TCGA 1992 a husband and wife while married and living together can have only one "residence or main residence" between them. This means in particular that where, as often happens, each spouse brings one or more properties to the union, they must decide on or following marriage which is the one to which the exemption should most advantageously attach and, if not obviously the main residence, the desirability of giving to the Inspector a notice signed by both spouses under s.222(5)(a), within two years after the date of marriage. All statutory references in this article are to TCGA 1992, unless otherwise stated.

Following the marriage a disposal of, or an interest in it, a property by one spouse to the other will take place on a no-gain no-loss basis under s.58 (although note the special rule here for the period of ownership under s.222(7), which is discussed below). This means that the transferee spouse will take over the indexed base cost of the transferor (note, not necessarily donee and donor, since the transfer may be for value).

The decision as to the property in favour of which the election should be made will be affected not only by the relative prospects of capital appreciation, but also the question of which property is to be sold first, especially if within thirty-six months of the marriage. In the latter case, complete exemption should in principle be obtainable under the last part of s.223(1). A disposal of an interest in the property to the other party before the marriage, even if during

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the year of marriage (distinguish the rule for the year of separation or divorce: see below), will operate in the same way as a transfer of any other asset between two taxpayers, viz, market value will apply under s.17, and the transferee will have an acquisition cost equal to the market value of the interest at the date of transfer.

The Rule in s.222(7)

S.222(7) applies where there is a disposal of a dwelling-house or part by one spouse to the other. Para (a) treats the transferee's period of ownership as beginning with the period of ownership of the transferor. This gets over a problem that could be presented by the no-gain no-loss rule of s.58. Further, under para (b), in a case where the dwelling-house was not the only or main residence of both spouses throughout the transferor's period of ownership, to the extent that during that period the house was the transferor's only or main residence it is treated also as being the transferee's.

Example

Zeus and Hera each own a flat when they get married in 1988. They decide to live in Hera's rather more up-market residence and want advice on the implications of letting Zeus's. If the property is let on an exclusive basis, it will of course mean that the flat ceases to be occupied as their residence. However, if the special lettings exemption under s.223(4) applies there will be no gain on disposal. Given that (interestingly) this exemption is given to each of husband and wife, it might be sensible to transfer Zeus's flat into joint names, assuming that a sale is likely. Accordingly, Zeus moves out of his flat and moves into Hera's. They will of course have only one residence and it will not be open to them to make a s.222(5) election. As an income tax planning point, depending on the respective levels of their other income, the ownership shares of Zeus's flat could be varied so as to make full use of any basic rate balance not otherwise employed.

Note that if Hera is to get the benefit of the special lettings relief she must have occupied the flat at some time as her only or main residence (though this can be after the period of letting). Depending on the figures involved and the prospective gain, they could (to the extent that Zeus's flat was not let) consider occupying the flat from time to time themselves to ensure that it remained a residence. This would enable them to put in an election in favour of his flat, being the one which they intended to sell first once the market had recovered.

The rule in s.222(7)(b) means that when they sell Zeus's flat Hera is able to take advantage of a pre-marriage period of occupation by Zeus, although until marriage her only or main residence had been her own flat.

Transfers on Death

S.222(7)(a) contains some rather curious words. Where the inter spouse disposal occurs on the death of one of them, the recipient spouse's period of ownership is still to begin with that of the deceased. The normal rule as to what happens on death is of course provided by s.62(1), namely the personal representatives or the beneficiary are deemed to acquire the asset for a consideration equal to market value at the date of death, but with no corresponding disposal by the deceased. Does this not apply in the present case?

If, notwithstanding s.62(1), the s.222(7)(a) provision is to be applied this could be explained as a hang-over from the original capital gains tax rule in s.29(8)(b) Finance Act 1965 when disposals on death were chargeable (the present tax-free uplift on death having been introduced only in 1971). In one sense at least there seems to be no direct conflict between the two provisions since s.62(1) is concerned with deemed consideration (and deemed disposals, or rather lack of them) and s.222(7)(a) with periods of ownership and actual disposals. The relevance of period of ownership in the case of a disposal of a main residence is of course that, given the provisions of s.222(7)(a) discussed above, the dwelling-house in question may not have been used as the only or main residence during part of that period and in particular by the deceased. This principle could work either to the benefit or to the disadvantage of the taxpayer.

Consider the following example:

Pericles is the sole owner of the matrimonial home which he acquired when a bachelor in September 1988 for £80,000. He was then at University and did not live in the house until September 1990. In September 1991 he married Aspasia and they lived in the house together for a year until his unfortunate death in 1992 when the house was worth £150,000. Aspasia lived in the house for a further year before selling it for £200,000.

Aspasia's period of ownership was treated as having begun in 1988, but since it was not Pericles' main residence throughout his period of ownership she is fixed with the non-residential use, in this case two of those four years.

Although her acquisition cost is the value at the date of death of £150,000, only three-fifths (60%) of her gain will be exempt.

Consider another example:

Socrates bought a house for £50,000 in 1982 which he occupied as his residence before marrying Xanthippe in 1985. 1986 Socrates was killed, leaving the home to Xanthippe under his Will and (following a short period of residence) Xanthippe decided to retain the house, though keeping it vacant, while returning to her own home to live. She eventually sold the house in 1992. In this case the period of non-qualifying ownership occurs after the death and therefore the chargeable fraction is effectively reduced from three-sixths (50%) to three-tenths (30%) since under s.222(7)(b) Xanthippe can take advantage of Socrates' period of owner-occupation before she married him.

Perhaps in something like the above respective circumstances, Xanthippe would argue for the application of s.222(7), whereas Aspasia would claim that the last limb of s.222(7)(a) had become redundant following 1971 and that she could not be prejudiced by a period of non-owner-occupation on the part of her deceased spouse before ever she acquired an interest in the property.

Transfers on Separation or Divorce

Although the spouses will (usually, at least) then cease to be living together, the no-gain no-loss transfer provisions of s.58 would still apply in the year of separation, since at some time in the relevant year of assessment the spouses will have been living together. After the following 5th April, or indeed if they have become divorced in the interim, s.58 will no longer apply. Compare the connected persons rule in s.286(2) which keeps two people connected so long as still married, even if separated; a gift between them is treated as made at market value and any gain cannot be held over.

The matrimonial home will typically form a major part of the matrimonial settlement, whether the home is jointly owned or is owned by one or other of the spouses. Where, as is typically the arrangement, the wife and children remain in the home and the husband leaves to live elsewhere, a problem will arise on a subsequent disposal of the home by the husband or of his share in it, since for the period between his ceasing to live there and sale it will not have been his residence. Generally, it is important to identify when separation occurs and to review any main residence elections made hitherto.

The Concession

While extra-statutory concession D6 attempts to deal with this problem it does not go very far. Under the concession, if in such circumstances either spouse, say the husband, disposes of the home or an interest in it to the other, his wife, as part of the financial settlement, the home can be regarded for main residence relief purposes as continuing to be his residence, provided that throughout that period it was the wife's only or main residence. This, not unnaturally, depends upon the husband not having elected that some other house should be treated for capital gains tax purposes as his main residence for that period. However, the concession does not deal with the case where the husband has acquired another property which he has in fact occupied as his only or main residence (even if he has not elected as such). It may be that on a subsequent disposal by the husband of that other residence, he could not claim relief for the period in respect of which relief was claimed on the disposal to his ex-wife, although the point is left open by the concession.

However, the terms of the concession are very narrow and would not, for example, cover a sale by the husband, or by husband and wife together if joint owners, to a third party. In order to bring the parties within the terms of the concession, there would first have to be a transfer by husband to wife, with any tax implications that that might involve, and then an on-sale of the whole by the wife to the third party. It appears that there may be cases when an Inspector of Taxes is generous in applying the concession where the disposition takes place direct from the non-occupying spouse to the third party purchaser, perhaps on the basis of a general authority granted to Inspectors by the Board of Inland Revenue to exercise their discretion in interpreting the terms of any concession, though of course this cannot be relied upon. Alternatively, and perhaps more simply when circumstances allow, the interests of both parties could be transferred to trustees, for the benefit of both in prescribed shares, with exemption available on eventual sale under s.225 (one of the beneficiaries being entitled to occupy under the terms of the settlement - see below under Mesher Orders).

The Period of Ownership Following Separation or Divorce

Here an interesting point arises. Consider what happens if a transfer of the whole property, say from husband to wife, occurs after separation but during the tax year of separation. What is the effective date of the transferee's acquisition? So far as her base cost is concerned, s.58 would apply to treat her as having acquired the property at her husband's original acquisition cost or

March 1982 value, plus indexation allowance to the date of transfer, though s.58 itself does not address the question of time of acquisition.

There is a provision in Sch 2 para 17 which imports the date of the donor's acquisition; however, this applies only for time apportionment purposes. S.222(7)(a) applies only to a transfer of a dwelling-house or an interest therein which *is* the spouses' only or main residence and this, by definition, it would have ceased to be following separation. Accordingly, there would appear to be nothing to prevent the transferee's date of acquisition from being that falling on the date on which his or her interest in the property first arose. Whether this is advantageous or disadvantageous would of course depend upon the facts. The transferee is certainly fixed with the historic base cost, though if he or she thenceforth uses the property only as his or her main residence this will not matter.

Example

Menelaus bought a flat in 1985 for £50,000, half of which he used for his business until 1988 when he married Helen. They separated in 1991 after which, but in the same tax year, Menelaus gave the house to Helen as part of the matrimonial settlement. Although the house was then worth £120,000, her acquisition cost is treated as being £50,000 uplifted by indexation, with no chargeable gain made by Menelaus. If Helen then lives in the house until selling it, there will be no restriction by virtue of Menelaus's previous business use (her period of ownership commencing with the gift), which there would have been had she, for example, inherited the house on Menelaus's death (albeit with a gain based on probate value), assuming the interpretation of s.222(7) discussed above.

Mesher Orders

Sometimes one of two Court Orders may be made by a Court in divorce proceedings. Following the Court of Appeal decision in *Mesher v Mesher and Hall* [1980] 1 All ER 126 the Court can order that the home be put into joint names on trust for sale, but with a postponement of sale until, say, the youngest child attains 18 with the wife and children residing there in the meantime. The sale proceeds are then divided according to the shares in the property. On making the Order there may be a disposal for capital gains tax purposes, though it would be hoped one not chargeable to capital gains tax. There are unlikely to be any implications for inheritance tax; in particular,

there will be no settlement for inheritance tax purposes under s.43(2) IHTA 1984. On sale, the share accruing to the wife will be exempt within the main residence relief.

Prior to an apparent recent change in interpretation by the Revenue, the gain accruing to the husband would be chargeable in part in that he would not have occupied the home as his only or main residence throughout the period of ownership. However, the Revenue have now determined that a Mesher Order gives rise to a settlement. On the making of the Order each of husband and wife will transfer his/her share to the trustees of the notional settlement, the disposal protected by the main residence exemption. On sale following the youngest child attaining 18, the whole gain will be exempt under s.225, given that the wife is one of the beneficiaries and entitled to occupy the property, even though the husband might have had his own residence in the meantime.

Charge

For capital gains tax purposes this increases the attraction of a Mesher Order, in particular over an Order by the Court for transfer by the husband to the wife of the entire ownership in the property but subject to a charge in favour of the husband on sale. The charge would be either for a fixed sum or for a share in the proceeds of sale and may carry interest meanwhile. For capital gains tax purposes the husband would be disposing of his interest at the outset, presumably free from tax, and similarly on ultimate sale the wife would receive the proceeds free from capital gains tax.

The implications of the receipt by the husband will depend on its nature. If the charge is for a fixed sum, no liability to capital gains tax will arise by virtue of s.251(1). Interest accruing in the meantime would of course be subject to income tax. If, on the other hand, the charge entitles him to receive a proportion of the proceeds of sale he would be disposing of a chose in action chargeable within the principles established by *Marren v Ingles* 54 TC 76. A calculation is required of the value of the right when it first arose, and the gain on sale will equal the excess of the sum received over the indexed amount of such value.

This article has concentrated on the capital gains tax implications of the transfer of a share in the residence as between spouses. It has touched on, though has not developed in any detail, the main residence election; in concluding, it should be emphasised that very careful attention needs to be given to the matter of the election, both on, during and following the end of a marriage, given the

special rules for husband and wife. As with any taxpayer, main residence elections need to be kept under careful review.