



CAPITAL GAINS TAX PRINCIPAL PRIVATE RESIDENCE RELIEF

A technical outline of the tax planning opportunities
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INTRODUCTION

Principal private residence (“PPR”) relief is designed to allow individuals to sell a home and buy a new one without incurring capital gains tax.

As with most reliefs, the rules contain a number of sometimes quirky rules that both offer opportunities for effective tax advice and traps to avoid. This publication includes both varieties.

It is assumed that the basic rules are understood by practitioners but for completeness we have included extracts from HMRC manuals and legislation which practitioners may find useful.

Statutory references are to the Taxation of Chargeable Gains Act (“TCGA”) 1992 unless otherwise stated.

References to married couples also apply to civil partnerships.

PLANNING OPPORTUNITIES

1. Flipping

This idea has received prominence in 2009 due to its use by a number of MPs and came to light around the same time as the expenses scandal. The technique is totally legal of course and constitutes good tax planning. However, some have suggested that it is some way down the line towards what is termed unacceptable tax avoidance. This is left to the reader's judgement.

Oddly the technique used to be described in detail in HMRC's own manual at CG64510. Surely it cannot be unacceptable then?! Whether this was to assist MPs is left to the reader's imagination!

This read as follows:

A notice given under TCGA92/S222(5) can be varied by a further notice which can be given at any time. But such a further notice is only effective for a period beginning not earlier than 2 years before it is given.

A variation will often be made when the disposal of a residence is in prospect or has already taken place. The intention is to secure the final period exemption, see CG64985+, on the residence to be sold at the cost of a minimal loss of relief on the residence retained. This is illustrated by the example below.

A person has had two residences for many years, residences X and Y. He has submitted a valid notice nominating X as his main residence. On 1 January 1992 he disposes of Y and realises a large gain.

In order to obtain some relief in respect of that gain, on 1 February 1992 he submits a variation to his original notice which nominates Y as his main residence from 1 February 1990. On 8 February 1992 he submits a further variation which nominates X as his main residence from 8 February 1990.

So Y has been validly nominated as his main residence for one week in February 1990. As Y has been his main residence for this period he is entitled to the final period exemption, see CG64985+. For a disposal in 1992 this was 36 months. The result is that at the expense of a loss of one week's relief on X he secures three years relief on Y.

End quote

This paragraph in the manual was amended on 13 May 2010 and is now much less detailed. The reason for the amendment is also left to the reader's imagination!

The rules regarding making elections under s222(5) are considered in more detail in the next sections.

2. More than one residence - elections

A person is only allowed to claim relief on one residence (subject to some exceptions). If a person has more than one residence, relief is given on the property considered to be the main residence [s222(1)(a)]. This is determined as a question of fact. However, s222(5) allows a person to make an election within two years of acquiring a second residence as to which will be treated as his main residence. Thus the election allows the property not used as the main residence to be deemed to be the main residence.

Once an election has been made within the time limit, the election can be varied at any time with the effect backdated by up to 2 years [s222(5)].

Opportunity

It is important always to make an election within the two year time limit when occupying more than one residence. This is the case even if the election is made in favour of what would be regarded as the main residence as a question of fact. Failure to do so means that the opportunity to change the election (see the example under Flipping above) is lost.

3. More than one residence – missed election

Is all lost if the two year time limit is missed? Not necessarily. If a third residence is acquired there is a fresh opportunity to make an election – now between the three properties.

In paragraph CG64500 in HMRC's Capital Gains Manual, HMRC confirms that any property can be a residence even if the person does not own it, e.g. a flat rented on a weekly basis.

Thus the third property acquired could be rented – it is not necessary to buy another property. But, although the quality of ownership is not important, the quality of occupation is important. The property must be genuinely used as a residence. This issue is considered in more detail in section 5 below.

4. More than one residence – unmarried couples

A married couple or civil partnership are only allowed a single PPR [s222(6)] and any election under s222(5) must be made jointly. However, this does not apply to unmarried couples.

Opportunity

If an unmarried couple own two residences then maximum relief can be obtained by each owning one property outright rather than owning the two properties jointly. However, it is advisable that each person make a s222(5) election in favour of the property they own. This is because both properties might be considered residences for both of them, even though they each do not own one property. It might be argued that each party only has a gratuitous licence to occupy the property they don't own [see CG64470] but it is unsafe to rely on this particularly if both parties contribute to the upkeep of both properties. ESC D21 provides an extended time limit to make an election where a person is not aware of the need to make one and he only has a negligible interest in one property but, again, it is unsafe to rely on this.

5. Let property

When calculating PPR relief, there is an exemption for at least some of the gain attributable to a period when the property is let [s223(4)]. The letting might occur whilst the owner remains in the residence (for example with a bed and breakfast business) or might occur when the owner is living elsewhere. The latter is the more common situation.

The relief is capped at the lowest of

- a. The gain attributable to the letting
- b. The gain eligible for PPR relief excluding letting relief but inclusive of the final 36 months
- c. £40,000 (this being per person so a property owned by a couple would be eligible for up to £80,000 relief)

Opportunity

Consider the following example:

A person has owned a residential property that has been let for the past 5 years. The tenant has left and the landlord is considering selling it. He moves into the property at, say, weekends, perhaps to allow him to redecorate in preparation for a sale. He now has two residences and elects for this property to be his main residence varying the election to his other property after a week (see section 1 above). 6 months later he sells the property.

Because the property has been his PPR for one week, he is eligible to claim the final 36 months as exempt. On the back of this he can claim up to a further 36 months as exempt due to letting (subject to the £40,000 cap).

In this example the total ownership period is 5½ years so prospectively the whole gain is exempt for the loss of one week's relief on the main property.

The key to make this work is establishing a genuine period during which the property is used as the person's residence. There is no legislation as to what constitutes residence and so common sense must apply. In other words it is more than just sleeping in the property overnight once or twice. In particular it is not clear what minimum period of occupation is required. In *Goodwin v Curtis CA [1998] STC 475* it was held that: "the principle is that in order to qualify for the relief a taxpayer must provide evidence that his residence at a property showed some degree of permanence, some degree of continuity or some expectation of continuity". Some advisers recommend a period of at least 6 months. In the light of a series of recent Tribunal cases - *Favell [2010] TC 00642*, *Moore [2010] TC 00710*, *Springthorpe [2011] TC 00832* and *Lowrie [2011] TC01170* - where the taxpayer has lost on each occasion, even 6 months is probably optimistic – particularly in relation to a part-time residence.

As occupation is not exclusive such issues as changes of address and voter lists are not relevant but it is sensible to obtain some evidence of occupation in case of challenge from HMRC. The imagination can run wild here but possibilities include making oneself known to neighbours (perhaps to tell them he is only there part of the time) and trying to ensure the neighbours see him

as often as possible when he is there and getting regular deliveries (groceries online?) to the address retaining any paperwork with the address on. Basics include keeping some clothes and personal possessions there and it should be furnished!

6. Divorce

When a divorce occurs, it is normal for one party to leave the matrimonial home. Sometimes the property is sold. The departing spouse will obtain full relief for his share of any gain provided the sale occurs within 3 years of his departure. If the property is sold at a later date then the gain will not be wholly relieved.

If the departing spouse transfers his share of the property to the resident spouse, it is deemed to be a disposal at market value. The same principles will apply as in the previous paragraph. However, under s225B (formerly ESC D6), if the departing spouse does not have another PPR he can deem the original property to remain his PPR if the remaining spouse continues to so use it.

Where the departing spouse intends to acquire another property but there is no wish to transfer the original property to the remaining spouse, a tax efficient option is to obtain a Meshor order. This puts the departing spouse's share of the property into trust on terms that allow the remaining spouse to occupy it until a specified event (e.g. remarriage or the 18th birthday of the youngest child) at which point the property is sold and both parties receive their shares.

As a beneficiary of the trust (the remaining spouse) is entitled to occupy the property under the terms of the trust, relief is available for the whole gain under s225.

RISK AVOIDANCE

1. Selling a slice of the garden

PPR relief not only applies to the house but also to “land which he has for his own occupation and enjoyment with that residence as its garden or grounds up to the permitted area” [s222(1)(b)].

Particularly in the past, it is not unusual for a person with a large garden to sell a slice for development. Courts [see *Varty v Lynes* (51TC419)] have held that the person must continue to be in occupation of the house at the time the slice of garden is sold.

Trap 1

If selling a house and a slice of garden separately ensure that the contract for the sale of the house is not completed before the contract to sell the land is signed. This is discussed in detail in CG64385.

Trap 2

It is also important to ensure that the land remains part of the garden until contracts are exchanged. This means that it should not be fenced off or separate title created in the Land Registry until after that date.

2. Building a house in the garden

Sometimes a person with a large garden might decide to build a new house for his occupation in part of the garden and sell the original house with the remaining garden.

What PPR relief is due if he later decides to sell the new house?

Let us assume that the original house was acquired in 2000, the new house built in 2010 and sold in 2020.

The date of acquisition of the new house is 2000, when the land was acquired. But the new house was not the person’s PPR until 2010, as it did not exist! The fact that the land was part of the previous PPR is irrelevant. So only 50% of the gain is eligible for relief.

Solution

The way to avoid this problem is to engineer a disposal of the land in 2010 **before** the new house is built (see Trap 2 above). This could be to a trust set up for the benefit of the settlor. This would trigger a disposal at market value (exempt due to PPR relief) but, more importantly, the trust’s acquisition date would be 2010. The settlor could occupy the property as beneficiary of the trust and the whole gain in 2020 would be eligible for relief [see s225].

3. Absences

Absences from a property can cause problems in a number of ways.

Trap 1

If a property is acquired with the intention of using it as a residence and is later sold, perhaps because the owners changed their minds or faced financial difficulties, without ever having occupied it then no PPR relief is due. The only exception to this rule is where a person living in job related accommodation acquires a property that he intends to use as a residence [see s222(8)].

Trap 2

The legislation in s223 allows certain periods of absence (up to 3 years for any reason, any length when working abroad and up to 4 years because of work requirements) to be deemed to be periods of occupation. However, for these to apply, there must be actual occupation both **before** and **after** the period of absence.

4. Married couples and civil partnerships

If an asset is transferred between spouses, it is deemed to be sold at a price that does not generate a capital gain or loss [s58]. This is before the application of PPR relief.

Where there is a transfer of ownership of part or all of a PPR, s222(7) provides that the ownership period for the transferee is deemed to be when the transferor acquired it and periods of use as PPR by the transferor are deemed to be such periods for the transferee (in a case where the transferee had not used the property as the PPR).

This means that, if one party has a PPR prior to marriage and transfers half to the new spouse, the new spouse will inherit the PPR status of the transferor.

Trap

The rule in s222(7) only applies if the property is being used as the PPR at the time of transfer. Thus, in the example above, if both parties owned PPRs prior to marriage, moved into one property on marriage and if ownership of the other property is transferred afterwards, PPR relief on the part transferred is lost.

COMPLIANCE ISSUES

Claims for PPR relief are included in the Tax Return. In simple cases where there is only one residence and is wholly exempt, there is no need to include it on the return.

In more complex cases, even if relief is being claimed for the whole gain, it is important to disclose the relevant facts on the return.

Elections and variations of elections under s222(5) do not require any specific forms and so can be made by letter to the relevant tax office. These should be signed by the client (jointly where applicable and copies sent to both tax offices if different offices are involved).