

## DISPOSAL OF MAIN RESIDENCE OR SECOND HOME

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### Introduction

One of the most valuable tax reliefs for an individual is the exemption from Capital Gains Tax (CGT) which applies on the sale of the person's own home. Any gain on disposal is exempt, and any loss is non-relievable. The above represents the bare bones of the relief. Naturally, a number of conditions have to be met in order to qualify for this relief. Although the relief can be fairly straightforward, many complications can arise in practice. For example:

- What happens if there was partial business use of the house?
- What happens on divorce or separation?
- Does the exemption apply if you sell part of the garden?
- Does the exemption apply if you let the property for a period while working abroad?

We consider these matters below, and we hope to demonstrate that it is possible to maximise the benefit of the tax relief with the help of some advance planning ahead of disposals.

### The Basic Relief

The relief applies on the disposal of a person's private residence.

Of course, the exemption covers houses and flats. It may also cover a houseboat which is on a permanent site and is connected to all main services. A static caravan may also qualify, as long as it is connected to main services.

In the case of a married couple (or civil partners) only one property qualifies for exemption. There used to be an additional exemption for a property provided for a dependent relative of the taxpayer, as long as it was provided rent-free and without any other consideration.

This exemption is no longer available, subject to a possible exemption if the property was the sole residence of the dependent individual on 5 April 1988 (or any earlier time in the taxpayer's period of ownership).

## Periods of exemption

If the house is your main residence for the entire period of ownership, then full exemption will be available on disposal, unless – of course – there is an element of letting or business use (see below).

It should be borne in mind that for CGT purposes a person normally acquires a property on the exchange of contracts, not completion. Similarly, the relevant date for disposal is normally the date of the exchange of contracts.

If part of the period of ownership does not qualify for exemption, then the proportionate part of the total gain will be chargeable to tax, subject to possible reliefs – see below.

If you do not occupy the property as soon as you acquire it, the exemption will apply for the first 12 months of ownership. This allows you time to make alterations, or even to build a house on a plot of land, and the exemption applies even if you have another main residence during the period. The Revenue have discretion to extend this period to up to 24 months. It is important to note that, if you exceed the permitted period of non-residence, you lose the entire initial exemption, not just the excess. Thus, if you take 14 months before moving in and the Revenue refuse to grant an extension, then the exemption will be lost for the whole period of 14 months.

Turning to disposal, the legislation recognises that there may be a delay in selling the property after you have moved out. The last 36 months' period of ownership will, therefore, qualify for exemption, even if you have another main residence. If disposal takes (say) 40 months, you will still qualify for the 36 months' exemption.

The above reliefs are quite generous, but further reliefs may also apply: -

- (i) A period (or periods) of absence not exceeding three years.
- (ii) A period throughout which the taxpayer worked as an employee and all the duties of the employment were performed outside the UK.
- (iii) Any period of absence not exceeding four years throughout which the taxpayer was prevented from living in the property due to the location of the place of work or the demands of the employer.

The above three periods apply only if the property was the taxpayer's main residence both before and after the period(s) of absences. If the taxpayer has another main residence during the period(s) of absence – e.g. a rented property while working abroad – he/she can make an election (see below) to treat the original property as the main residence during the period(s) of absence.

There is also a special exemption for people who live in job-related accommodation while maintaining a separate main residence. This relief is quite narrow in scope but we can advise you further if you think that this may be relevant to you.

## Husbands and wives

A husband can transfer his interest in the main residence (and other assets) to his wife on a tax-neutral basis (and vice versa).

If the husband had a separate main residence from the wife at the date of marriage, then up to that date each will have been entitled to a separate exemption, assuming the various conditions were met. However, after marriage they are only entitled to one main residence between them. Commonly, one of the residences will be sold within three years of marriage and this will qualify for exemption under the rules described earlier.

They may, however decide to retain both properties. In that case they need jointly to elect for one of the properties to be regarded as the main residence from the date of marriage. This election has to be made within two years of marriage.

If a husband and wife separate they can make transfers from one to the other on the tax-neutral basis throughout the tax year in which separation occurs (or up to the date of divorce if this is in the same tax year). Thereafter the tax-neutral treatment ceases.

This means that great care is needed in order to ensure full tax exemption on disposal of the main property in connection with divorce.

The following is a common situation. Husband and wife separated in (say) February 2007. They jointly owned the main residence. The husband left the family home and bought another house for himself. The divorce is expected to occur in March 2008.

As part of the divorce settlement the husband will be transferring his share of the main residence to his wife. That transfer will be in 2007 – 08 and will not qualify for the tax-neutral treatment referred to earlier. He will be regarded for CGT as selling his share of the property to his wife at market value at the time of the divorce settlement. As long as this occurs within three years of it ceasing to be his main residence he will have no CGT liability.

If there is a long delay in connection with the divorce, so that the formal transfer to the wife is made (say) four years after separation the husband can still obtain exemption, by reason of a Revenue Concession. However he will not be entitled to claim exemption in relation to a second property during this same period.

## **Civil Partnerships**

The new rules on civil partnerships came into effect on 5 December 2005. Once a same-sex couple have entered into a formal civil partnership they qualify for the same capital gains tax treatment as a married husband and wife.

However prior to entering into the civil partnership each individual would have been entitled to the main residence exemption on a separate property, if appropriate. Once they have entered into the civil partnership they are entitled to the exemption on only one main residence between them. This does not, of course mean that there will be any immediate CGT liability. If one of the properties is sold within three years of ceasing to be the main residence of the vendors there is likely to be no CGT liability. If the partners intend to retain both properties they can jointly elect for one of the properties to be treated as the main residence in the future. Clearly care is needed in deciding which property to elect for. The election needs to be made within two years of entering into the civil partnership.

## **Business use of home**

If part of your home is used exclusively for business purposes then an appropriate proportion of the gain will be liable to CGT when you sell the property.

If you buy a further property to be used partly for business purposes then you may be able to “roll over” the gain into the cost of the new property, thus deferring the CGT liability.

Roll over relief is complex so please consult us if this is relevant to you. In principle the proceeds of the “old” property must be “reinvested” in the new property within one year before the disposal or three years after the disposal. Special rules apply if one or both of the properties is leasehold and the lease runs for less than 60 years.

The calculation of the gain on the disposal of a house which was used partly for business purposes is rather curious and an example is included in the Appendix.

## **Second homes**

We have already made reference to four situations where it may be possible for a person to obtain CGT exemption in respect of two main residences at the same time. These apply in certain narrow circumstances:

- In connection with marriage or entering into a civil partnership.
- In connection with divorce/dissolution of a civil partnership.
- Job related accommodation.
- If you move out of your home into another main residence but need up to three years to sell the old property.

If you are in any of these positions the matter needs to be carefully reviewed at an early stage, and we shall be happy to help you. As mentioned earlier, a main residence election may be needed in certain circumstances and this is subject to tight time limits.

If you have a second home, and the above circumstances do not apply, then you need to decide which property to elect as your main residence. This may well be the property which is likely to produce the greatest gain on disposal. On the other hand, if you and your family clearly intend to reside in one of the residences for a lifetime, it may be sensible to elect for the other residence which may be sold in a shorter timeframe.

It is important to note that you can only elect to determine which of your two residences is your main residence within two years from the date when you first used the second home as your residence. You can vary the election by way of a further notice (again subject to time limits). If you made no election then the Revenue may themselves determine the position, and this will not necessarily be to your advantage!

If you start to occupy a third property as a residence, then the right to make an election runs from that date, so you can nominate one of the three residences at that stage. This can be particularly useful if you missed the deadline for an earlier election.

### **Example**

Mr Green owns two private residences. One is located in Sussex, where his wife and children live. The other is a flat in London, close to his place of work. He lives there four nights a week, and spends three nights a week at the Sussex property.

He bought both properties about eight years ago at the time of his marriage. It appears that each house would qualify as his 'principal private residence', but he neglected to make an election within two years of occupying the second property, so HMRC can effectively make their own decision as to which property will qualify for exemption. This will not necessarily produce the best result for Mr Green on sale of one of the properties!

Mr Green is now about to buy a third property: a holiday home in France. This may open the way for Mr Green to make a formal election within two years to ensure (perhaps) that his London flat should be regarded as the principal private residence from that time onwards.

We can help you to review your position if you have a second (or third) home and – like Mr Green – have not yet made an election.

## **Garden/grounds**

The CGT exemption covers not only the house but also surrounding land which the owner has for “his own occupation and enjoyment” up to the “permitted area”.

This permitted area is 0.5 hectares (or 5,000 sq metres), or a larger area if this is required for the reasonable enjoyment of the property as a residence having regard to its size and character. If you have grounds of (say) three hectares, and HMRC determine that the permitted area is one hectare then the “excess” two hectares will not qualify for the CGT exemption.

If you are potentially in this situation you should note the following points: -

- If part of the grounds is physically separate from the main garden/grounds, that part may well be excluded from the exemption. This could apply, for instance, to a fenced-off paddock.
- If you sell part of the grounds but retain the house, this may be a strong indicator that the element sold was not needed for the “enjoyment” of the property.

It may be possible in certain situations to overcome this potential contention by HMRC, by arguing the sale was to a family member or was due to financial problems. Another problem arises if you sell your house but retain part of the grounds. When you subsequently sell the retained part, you cannot obtain the CGT exemption in relation to the period when you owned it together with the house. This is because the land must have been enjoyed with the house at the time of disposal of the land. This ruling applies even if the “original” grounds fell within the 0.5 hectares “permitted area.”

## **Letting**

The rules relating to let property are very complicated.

In principle, if your home was let for part of the period of ownership, then the gain on disposal will be apportioned along similar lines to the example in the Appendix.

If the letting was residential there is a special relief on disposal. The apportioned gain relating to the let element can be reduced by £40,000 or (if lower) the amount of the main residence exemption. If the property is owned by both husband and wife (or civil partners) they each qualify for this relief. There may be difficulty in obtaining this relief if the property is let on a rent-free basis.

## Summary

It can be seen from the above that the special CGT reliefs on disposal of a main residence are potentially very valuable. It is important to keep your position constantly under review if you have more than one residence, and the deadline for election should of course be met, where appropriate.

If you are planning to sell part of your garden, then it may be possible to save tax, as demonstrated above as long as the position is carefully considered in advance.

### **FOR GENERAL INFORMATION ONLY**

Please note that this Memorandum is not intended to give specific technical advice and it should not be construed as doing so. It is designed to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic. Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.