Double trouble

MALCOLM GUNN examines various quirks of capital gains tax on holiday homes.

Anthony and Cleo are a married couple and own two properties. Grimy Towers is in London and the other is a holiday home called Pyramid View, which rather strangely is in Rome. Like most people they do not understand why they should pay any capital gains tax on either property if they decide to sell one. Sadly, I had to tell them that some disaster lay ahead on that score. However, perhaps I could change the course of history a little. Because Anthony was born in Italy and Cleo in Egypt, I was surprised to learn that they are now UK domiciled and resident.

The first question is to determine which property is their main residence. Assuming that the property in Rome is used less often than the London home, where they live most of the time, HMRC will undoubtedly conclude that the London property is, on the facts, their main residence.

Would they be able to elect for Pyramid View to be their main residence for a short period to have some exemption when they come to sell? The learned authors of *Whiteman and Sherry on Capital Gains Tax* suggest that a holiday home may not qualify as a residence, given the requirements that there must be occupation of the property with some degree of continuity and permanence for it to be within the meaning of that term. With a holiday home, the owners may often visit only for comparatively short periods, so it will not then qualify as a residence of theirs.

What is a residence?

The problems here date back to the Court of Appeal decision in *Goodwin v Curtis* [1998] STC 475 in which reference was made to the meaning of the word "reside" in the *Oxford*

KEY POINTS

- The problems with defining exactly what a residence is for capital gains tax relief.
- Reduction in the final period of ownership for main residence relief.
- The suggested alternative methods of determining which property qualifies for relief.
- Transfer of property between couples and the implications of having made an election.
- Interaction of main residence relief, letting and other reliefs.

English Dictionary. This was given as "to dwell permanently or for a considerable period of time". So it was said that, unless a property is lived in for a considerable period, it will not be a residence.

Instinctively, one feels that something is going off the rails here. The extraordinary consequences that follow from this reasoning were amply illustrated quite recently in the case of *P Moore* TC2827. Here, the taxpayer was foolish enough to have been rather indecisive about his occupation of his only home, which lasted some eight months. This enabled the tribunal to find that he did not "dwell permanently or for a considerable time" at the property and so there was no capital gains tax relief for it. Heaven knows how long one now has to stay in a property for it to be permanent enough: two years, five years? Perhaps it will never be a residence if the owner always plans to sell, but takes many years to do so. Certainly, the man on the Clapham omnibus would say that the property Mr Moore lived in was his residence. If not, what was? Nowhere? For eight months?

It may be that all the problems flow from the Court of Appeal looking at the wrong definition. It looked at the word "reside", but the word it should have looked at is "residence", which is defined as "a person's home, particularly a large and impressive one". The Queen is "in residence" at one of the royal homes whenever she is there for a few days. There does not seem to be the same connotation of permanence with the word "residence" as there is with "reside". For me, the distinction is between a person having a place that is their residence and being of no fixed abode. Otherwise we have no English word for a "temporary residence", which counsel for the taxpayer argued in *Godwin v Curtis* was a contradiction; if residence has to be permanent it cannot also be temporary.

Even so, on the authorities as they stand, we must conclude that in terms of a property being someone's residence in terms of main residence relief it will be fatal to the case if he or she admits to being there temporarily only. It must be sufficiently furnished for ordinary use and the person must make regular ongoing use of it as a home for suitable periods.

Elections

As long as a holiday home satisfies the test of being a residence, there can be the opportunity to elect for it to be the main residence for a short time.

In another strange twist relevant to these capital gains tax provisions, it was held in *Griffin v Craig-Harvey* [1994] STC 54 that the election must be made within two years of the start of the period of ownership as a residence (although the legislation does not say as much).

There has been some re-drafting of the relevant provision so that decision has been called into question, but HMRC consider that it still applies.

From 6 April 2014, the election will achieve a lot less than it did beforehand. It will give an automatic 18 months of relief until the time of disposal, or a period of ownership if less. This reduction from the three-year period which applied before 6 April was something of a shock in the 2014 budget, but in fact the three-year period was introduced in the 1991 property slump and it had previously been set at two years in 1980. Originally, in 1965, only 12 months was allowed, so we are still slightly up on that deal.

Consultative document

As part of the government's drive to collect more tax from wealthy foreigners, a consultative document published on 28 March 2014 contains suggestions for removing the election provisions entirely. See John Endacott's article "Not that simple" (*Taxation*, 1 May 2014, page 11) for further details. Instead, we might have a rule which bases main residence on the property in which a person has been present on the most days in a given year.

Good luck with that idea; the hope that people will keep daily records of which property they were in on that day for the whole of their lives is not likely to catch on. They might not want various people to know.

An alternative is offered in the document which is that the main residence will be defined according to the facts. It mentions the address where the spouse or family lives, where mail is sent, and where the property owner is on the electoral role.

It seems to me that replacing a system that has worked relatively well since its inception in 1965 with one that will undoubtedly give endless trouble and argument does not seem worth it just to collect more tax from a small number of wealthy persons overseas. However, we have a mix of politics and tax here, so common sense will be the last thing on the minds of those responsible.

Couples and civil partners

A special rule applies to married couples and civil partners if a property which has previously qualified as the main residence is transferred between them. The transferee acquires the transferor's period of ownership. This rule applies whether it is a lifetime transfer or a transfer on death.

On the other hand, if the property has never qualified as main residence there is no backdating of the period of ownership, although the normal rule applies in that the transfer is on a no gain/no loss basis. As we shall see, some strange quirks follow from these principles.

This can be illustrated if we return to the example of Anthony and Cleo. Looking in more detail at their two properties, we can now apply some of these principles to their situation. Let us assume that Anthony owns Grimy Towers and Cleo owns Pyramid View.

Election or not

If they have in the past made a main residence election for Pyramid View, and Cleo then gives it to Anthony, he acquires it at her base cost and with her original acquisition date. So the 18-month exempt period, assuming a sale after 5 April 2014, is preserved, but of course the relief is steadily reducing in value the longer the property is held.

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On the other hand, suppose that they have never made any capital gains tax election. Cleo gives Pyramid View to Anthony who therefore acquires it at her original cost price, but his period of ownership for capital gains tax purposes starts on the date of transfer. Subject to the points already made about residences and anti-avoidance rules, he may be able to elect jointly with Cleo for it now to be their main residence and sell the property tax-free within 18 months of the gift to him by Cleo. This eliminates the gain entirely. In theory, this can make it far better for couples not to make an election for a holiday home soon after they buy it. But the plan would fail if Anthony meets with a tragic and untimely death before the gift.

Gift by will

If, after some tragedy, Cleo dies leaving Pyramid View to Anthony in her will and – contrary to what you might have heard elsewhere – Anthony survives her, the rules on the period of ownership remain as set out above. But Anthony acquires Pyramid View at probate value on her death. So if they had jointly made a main residence election for Pyramid View in the past, Anthony would be treated as having acquired the property when Cleo first bought it, but at a cost price equal to probate value. If the property increases in value after the date of death, any main residence relief will be apportioned over the whole period of ownership dating back to when Cleo bought the property.

In the alternative scenario of there never having been a main residence election for Pyramid View, there is no backdating of Anthony's period of ownership and he acquires it at probate value. He has the opportunity, within two years of the death, to elect for Pyramid View to have main residence treatment.

Letting reliefs

Suppose Anthony decides to let Pyramid View after he inherits it from Cleo. If there had previously been a main residence election for it, the letting relief of up to £40,000 could be claimed because the property has "at any time in his period of ownership" been the main residence. But this might not be of any help. In particular, if he sells within 18 months of the death, that period is covered by the main residence relief and so there is no gain in that period to which the £40,000 relief can apply [But see "Timely let", *Taxation* 14 April 2005, page 44 for an alternative view - *Ed.*].

If the property had never been elected as main residence, Anthony may now be able to make an election for it and if, at a later time, he lets it he may have some benefit from the letting relief provided that the period of letting is outside the final 18-month period of ownership.

Furnished holiday let

Finally, the position might be transformed if letting of the property were a furnished holiday letting business. There is no backdating of the period of ownership for other capital gains tax purposes, such as for rollover relief, and so for these purposes Anthony starts his period of ownership as from the date of acquisition from Cleo.

If, therefore, the furnished holiday letting at Pyramid View starts soon after a gift from Cleo and continues until sale of the property, Anthony could claim rollover relief for nearly all of the gain into a new qualifying property if a furnished holiday let business starts at that property on acquisition. It does not matter if that letting business ends after a few years because there is no provision to withdraw the rollover relief if the "trade" ends. Anthony will need to carry on the furnished holiday let business for a qualifying period, at least one year, to comply with the furnished holiday let rules. If he decides not to roll over the gain he should be able to claim entrepreneur's relief so that any gain will be taxed at the 10% rate.

With a furnished holiday let business, we might even combine the main residence letting relief with entrepreneur's relief. In the case of *Owen v Elliott* 1990 STC 469, heard in the Court of Appeal well before it decided that you are homeless unless you can say that you are living somewhere permanently, it was held that the relief for letting as "residential accommodation" applies not only to ordinary tenancies, but also letting as hotel accommodation.

There is a stark contrast here with decision in *Godwin v Curtis* since there is certainly not much permanent about the residential element in hotel occupation. So the letting relief applies equally to furnished holiday lets. Assume Anthony and Cleo in their joint lifetimes had elected for Pyramid View, at some later time starting a furnished holiday let business at the property. On eventual disposal they might have some main residence relief, some letting relief and also entrepreneur's relief. If it passes by will from one to the other before the lettings start, all these reliefs are applied to the gain on the rebased cost at the death. That's quite a cocktail of tax reliefs to help them through any other tragedies. ■

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