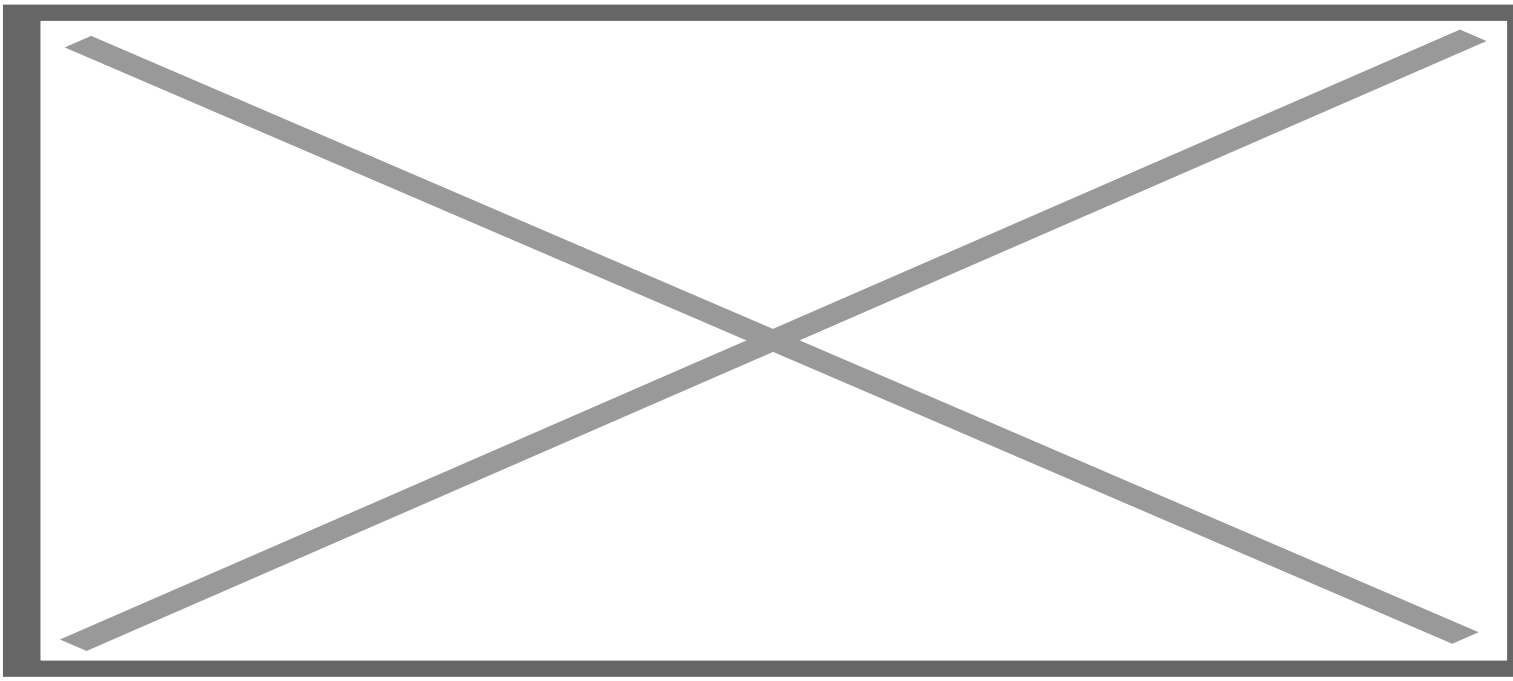
The availability of main residence exemption when a house is rebuilt

Personal tax



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The case of *Lee v HMRC* considers the availability of the main residence exemption when a house is rebuilt and the statutory definition of the ‘period of ownership’.

Key Points

What is the issue?

Earlier cases have shown that the period of ownership runs from the beginning of the time that a taxpayer has access to the property until the time at which the property is no longer available to him or her. However, the *Lee* case considers the situation where a house was constructed *during* the taxpayers’ period of ownership of the underlying land.

What does it mean for me?

The tribunal considered the statutory definition of ‘period of ownership’, which is found in the Taxation of Chargeable Gains Act 1992 s 222(7).

What can I take away?

The case serves as a useful reminder to ensure that dates of actual occupation as a residence are recorded so as to ensure that any exemption can be properly quantified.

Although nothing can be taken for granted, there is a general assumption that no UK politician would seek to extend capital gains tax to gains typically arising on a family home. Indeed, the 'main residence' exemption has been with us ever since the introduction of capital gains tax in the Finance Act 1965.

Equally, no one can expect such an exemption to be without certain conditions. For example, albeit with exceptions of its own, the main residence exemption is curtailed to the extent that the home was not the taxpayer's only or main residence throughout the period of ownership.

Earlier cases have (in my view, correctly) shown that, for these purposes, the period of ownership reflects the ordinary meaning of that phrase – so that the period of ownership runs from the beginning of the time that a taxpayer has access to the property until the time at which the property is no longer available to him or her. This distinguishes the phrase from the approach generally taken in capital gains tax, whereby acquisitions and disposals are treated as taking place when contracts are (or become) unconditional and not, if later, upon completion. For example, see the case of *Higgins* [2019] EWCA Civ 1869 (where the Court of Appeal allowed Mr Higgins's appeal from the Upper Tribunal).

However, the *Lee* case (*Lee v HMRC* [2022] UKFTT 175) has now considered the situation where a house was constructed *during* the taxpayers' period of ownership of the underlying land.

The facts of the case

Mr and Mrs Lee bought a property in October 2010. The land included a house. Over the next 29 months, the original house was demolished and a new house was built on the site. Within four days of completion of the building work (in March 2013), Mr and Mrs Lee moved into the new house and (it is inferred) occupied it as their only or main residence until they sold their interests in the site in May 2014. A gain arose on the disposal.

HMRC accepted that part of the gain was covered by the exemption, but considered that the exempt fraction was limited to 18/43. The denominator of 43 represented the number of months between the acquisition in October 2010 and the disposal in May 2014. The numerator would ordinarily have been 14 (being the number of months from March 2013 until May 2014), but for the special rule allowing the last 18 months of ownership to qualify for exemption (now, generally, reduced to nine months).

The case proceeded to the First-tier Tribunal.

The tribunal's decision

The case came before Judge Sarah Allatt and Member Celine Corrigan.

The tribunal considered the statutory definition of 'period of ownership', which is found in the Taxation of Chargeable Gains Act 1992 s 222(7). It provides as follows:

> '"the period of ownership" where the individual has had different interests at different times shall be taken to begin from the first acquisition taken into account in arriving at the expenditure which under Chapter III of Part II is allowable as a deduction in the computation of the gain to which this section applies…'

This had to be read in the context of the overall scope of the rules starting with s 222 itself. In particular, s 222(1) ensures that these rules apply 'to a gain accruing to an individual so far as attributable to the disposal of, or of an interest in 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'.

The Lees were arguing that the definition of period of ownership focuses on the dwelling house and not the underlying land. The tribunal agreed with this approach. As the tribunal noted: 'In every part of the legislation concerned, "period of ownership" would appear to attach to the "dwelling house" where the taxpayer may or may not reside.' Conversely, 'No mention is made of the land in reference to "period of ownership".'

Although the tribunal accepted that there was no 'clear definition of period of ownership', it felt that 'the natural reading of the legislation is that "period of ownership" means the period of ownership of the dwelling house that is being sold'. The result of the tribunal's decision is that the whole of the gain was exempt from capital gains tax.

In doing so, the tribunal positively disagreed with the Special Commissioner's decision in a similar case, *Henke v HMRC* (2006) SpC 550. Instead, the tribunal was comforted by the more recent (and binding) decision in *Higgins*, although the facts of that case were not so comparable.

Commentary

In one respect, I fully agree with the tribunal. That respect is its conclusion that there is no clear definition of 'period of ownership' that puts the question in this case beyond doubt. Indeed, this is a case where I would hesitate to give a definitive view. However, my starting point is that the outcome is surprising as it gives taxpayers (or at least some taxpayers) an opportunity to wipe clean a tainted period of ownership by demolishing an existing house and starting again (although that course of action might require some care for other reasons). But I would be the first to accept that surprising does not mean wrong. Far from it.

Nevertheless, I do not agree with the tribunal's statement that 'in every part of the legislation concerned, "period of ownership" would appear to attach to the "dwelling house" where the taxpayer may or may not reside'. Virtually all of the references to 'period of ownership' make no direct reference to the dwelling house but simply use the phrase 'period of ownership' in the way defined by s 222(7).

Of course, the set of rules starting with s 222 is focused on a dwelling house and, therefore, it is not surprising that one could interpret 'period of ownership' so as to mean the period of ownership of the dwelling house in question. In my view, however, that risks putting the cart before the proverbial horse. In particular, there is nothing in s 222(7) itself that expressly limits itself to the dwelling house itself. My view is that the phrase 'period of ownership' is more naturally attached to the asset, the disposal of which has given rise to the gain mentioned in s 222(1).

Of course, I must acknowledge that ss 222(8) and 222A (twice) appear to be exceptions to this rule, as they do refer to the period of ownership of a (or 'the') dwelling house. Accordingly, they definitely provide a clue that the 'period of ownership' could indeed relate to the dwelling house itself. However, s 222A was introduced relatively recently and should not be seen as an indicator as to how the phrase 'period of ownership' was intended to be interpreted by Parliament in the many instances where it was used prior to the enactment of s 222A.

Section 222(8), on the other hand, is of longer vintage. It was in place in 1992 when the legislation was consolidated and, in fact, it was found in the 1979 consolidation. Nevertheless, it was not a part of the original legislation (see Finance Act 1965 s 29) when the phrase 'period of ownership' was used on 14 occasions without

any qualification. In fact, what has become s 222(8) was inserted only in 1978.

It could be said that those three isolated references to dwelling house in the context of ‘period of ownership’ are therefore erroneous. Or it could be said (slightly more charitably) that the express use of the words ‘of the/a dwelling house’ are deliberately limiting the scope of ‘period of ownership’ in those three situations to periods during which the dwelling house in question is in existence. Either way, I do believe that the true meaning of the phrase ‘period of ownership’ elsewhere should be determined by looking at how it was used when the rules were originally enacted.

For completeness, I should mention that there is a rule of statutory interpretation that deprecates the analysis of pre-consolidated legislation, saying that it is the post-consolidation version that must be interpreted. That approach would require a tribunal to consider what is now s 222(8) as a part of the overall legislative picture. However, as one might expect, all rules of statutory interpretation are subject to exceptions in appropriate cases and I think that this is one such case.

For me, the most definitive clue is s 222(7) itself. That definition is undoubtedly drafted without reference to any particular dwelling house. Further, it makes reference to the actual times when acquisition costs are first incurred – such costs being those which are then deductible when calculating the capital gain. In a case such as the present, I would say that that points to a date long before the construction of the dwelling house: the date when the site was first acquired.

For these reasons, although the matter is not free from doubt, I think that the First-tier Tribunal reached the wrong conclusion.

What to do next

This is a case where I would expect HMRC to appeal against the First-tier Tribunal’s decision. Indeed, I would hope that some clarification of the law would be forthcoming. (If HMRC is to appeal, I hope that it would consider doing so on terms that mean that the taxpayer is not saddled with HMRC’s costs.)

In the meantime, and irrespective of the outcome of the case, it serves as a useful reminder to ensure that dates of actual occupation as a residence are recorded so as to ensure that any exemption can be properly quantified.