Private residence relief: a matter of construction

Property Tax | Personal tax

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The case of *HMRC v Lee* tackles the question of when the period of ownership of the main residence begins, and how this impacts capital gains tax.

Key Points

What is the issue?

When calculating the private residence relief available on a capital gain, does the period of ownership of the main residence start when the interest in the land is acquired or when the construction of the main residence is completed?

What does it mean for me?

This issue affects individuals who have built a property for themselves to live in, either by demolishing a property on the same site, or by building on bare land.

What can I take away?

In the recent case of *HMRC v Lee* [2023] UKUT 00242 (TCC), the Upper Tribunal held that the period of ownership starts when the construction of the dwelling-house is completed. One wonders whether the government will respond by amending the legislation.

Private residence relief has been a feature of capital gains tax since the charge was introduced in the Finance Act 1965. Nearly 60 years on, common situations continue to raise difficult questions about the operation of the relief. The recent case of *HMRC v Lee* [2023] UKUT 242 (TCC) considered a fundamental feature of the calculation – the period of ownership.

Under the Taxation of Chargeable Gains Act (TCGA) 1992 s 222(1)(a), private residence relief exempts from capital gains tax a capital gain arising on a 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 relief is calculated by reference to the period during which the dwelling-house has been, or has been treated as being, the disponer’s main residence divided by the period of ownership.

The period of ownership

In *Higgins v HMRC* [2019] EWCA Civ 1860, it was held that the period of ownership begins and ends when contracts are completed, rather than when they are exchanged.

In *Lee*, a separate question was posed to the Upper Tribunal: does the period of ownership start when the interest in land is acquired (the ‘land approach’) or on the physical completion of the structure which becomes the individual’s main residence (the ‘dwelling-house approach’)?

This is relevant where, for example:

- Type 1 scenario: an individual acquires bare land and builds a house on it to live in; or
- Type 2 scenario: an individual acquires a house, demolishes it, and then builds a new house to live in, as was the case in *Lee*.

In *Lee*, it was noted that these scenarios are 'not obviously catered for' by the legislation. Nevertheless, 'the question remains: how do the words of the legislation, construed in accordance with established principles of statutory construction, apply to the given facts?'

The position of the parties in *Lee*

HMRC adopted the land approach. If correct, Mr and Mrs Lee's period of ownership would have started in October 2010 when they acquired their original house. This would leave 29 months exposed to capital gains tax up to March 2013, when they moved into the new house that was built on the site of the demolished original house, thus starting their period of occupation. HMRC had, in their favour, the Special Commissioner's decision in *Henke v HMRC* (2006) SpC 550 (a Type 2 scenario) accepted the land approach.

The decision in *Gibson v HMRC* [2013] UKFTT 636 might also be regarded as supporting the land approach. In that case, the First-tier Tribunal held that the period of ownership in a Type 1 scenario cannot include the occupation of the house which has been demolished. The issue only arises if it is assumed that the period of ownership starts when the original land interest is acquired. Neither party in *Gibson* advanced argument on the issue, however, and the tribunal did not consider the issue expressly.

Interestingly, in neither *Gibson* nor *Lee* did the taxpayer consider triggering a deemed disposal under TCGA 1992 s 24(3) to reset the period of ownership and create a capital loss, as discussed in 'Demolition Job' by Sam Dewes (*Tax Adviser*, September 2021).

Returning to the *Lee case*, the taxpayers adopted the dwelling-house approach – arguing that the period of ownership started in March 2013 when construction of the new house was completed. On this basis, the house was their main residence for the full period of ownership, and no capital gains tax was due.

The First-tier Tribunal found in favour of the taxpayers and HMRC appealed.

The Upper Tribunal decision

The Upper Tribunal approached the issue in two stages.

1. Straightforward textual interpretation

First, the Upper Tribunal considered what it called the ‘matter of straightforward textual interpretation’. On this, it concluded that ‘the answer is clear: the taxpayers’ interpretation … is the correct one’.

In the extract from s 222(1)(a), quoted above, where the phrase ‘period of ownership’ is first used, it refers only to one asset – the dwelling-house.

In the absence of any specific definition, it is difficult to see how the period of ownership could be by reference to any other asset. Indeed, the Upper Tribunal said: ‘[S]ometimes drafting is silent for the simple reason that its meaning is considered obvious… HMRC’s interpretation requires not only reading in words, but reading in words which are not to be found in the section, nor indeed relevantly in any of the other provisions relating to private residence relief.’

2. Should the legislation be read differently?

Secondly, the Upper Tribunal considered HMRC’s wider arguments that the legislation ought to be read differently from the straightforward textual interpretation.

HMRC’s main contention, fundamental to the land approach, was that the dwelling-house is not capable of being owned separately from the ground on which it stands. Therefore, the period of ownership must refer to the asset acquired, being the

interest in land itself.

There is, though, no difficulty in determining the period of ownership of a leasehold interest in a flat, which does not include an interest in the land on which the block of flat stands. The relief applies to an interest in a dwelling-house, which is itself ‘land’ under English land law, and so that is what the period of ownership must also relate to.

What is more, Mr and Mrs Lee did not suggest that their interests in the dwelling-house were separate from their interests in the land. They merely suggested that their interests in the land did not include interests in the dwelling-house until the dwelling-house existed – a position which one might have thought was a simple truism.

Further arguments raised by HMRC relied on other parts of the legislation. For example, TCGA 1992 s 222(8) specifically qualifies the period of ownership in the context of that subsection as being‘of a dwelling-house’; and, according to HMRC,‘if Parliament had intended that “period of ownership” in s 223(1) to similarly refer to a dwelling-house it would have said so’.

Far from supporting HMRC’s land approach, the Upper Tribunal found these other legislative references to favour the dwelling-house approach. Section 222(8) did not introduce a new concept of the period of ownership; instead, it served as a reminder of the correct interpretation of the phrase elsewhere.

HMRC also argued that the dwelling-house approach meant that a taxpayer could benefit from private residence relief in respect of two properties at the same time (so called ‘double relief’) by living in another residence whilst the building works are carried out on the land and that Parliament could not have intended this result. Yet private residence relief has always allowed for some double relief because of the (now) nine months of deemed occupation at the end of the period of ownership. The Upper Tribunal found that ‘HMRC’s submissions in relation to double relief make assumptions about the nature of the relief which are not reflected in the operation of the legislation’ and ‘push past the limits of purposive interpretation’.

Policy implications

In a similar vein, the Upper Tribunal rejected HMRC's arguments about the policy implications of adopting the dwelling-house approach and in doing so raised some significant issues.

The start of period of ownership

The First-tier Tribunal held that the period of ownership under the dwelling-house approach begins when the house is completed. HMRC argued that this would lead to complex and subjective questions, such as 'when is the house completed?' and 'when is a renovation of a property substantial enough to start a new period of ownership?'

The Upper Tribunal was unimpressed by HMRC's objection. As it said, 'the application of a term to a particular set of facts is a task courts and tribunals are well versed in'. The comments on TCGA 1992 s 223ZA made by the Upper Tribunal also provide some guidance on this point.

Potential for abuse

HMRC expressed the greatest concern at the potential for taxpayers to abuse the dwelling-house approach. For example, an individual who has owned bare land for many years which has grown significantly in value might decide to build a very modest property on the land. Having lived in that property as his main residence, the individual might then sell the property and the land together and the whole capital gain would be exempt from capital gains tax.

Aside from the most basic requirement that a property becomes an individual's residence (which entails a degree of permanence), it is likely that the private residence relief anti-avoidance provisions and the GAAR would prevent abuse of the dwelling-house approach.

Since the case was heard, a number of articles have been published highlighting the supposed planning opportunities arising from the decision. Not every planning opportunity promoted in the press, however, is really practical.

One can construct potential situations which might be regarded as anomalous. A wealthy individual, for example, might buy a plot of land, or a relatively small house in a prestigious location, with the hope of acquiring planning permission to build a large house. The uplift in the value of the site, at least in the short term, is often almost entirely the result of the grant of planning permission. Even if the process of obtaining planning permission, demolishing the old property and building the property took many years, if the individual lived in the new property as his main residence on its completion up to the point of sale, the whole capital gain would be exempt.

Such an example is not necessarily an abuse of the rules, but the government may decide that full exemption in these circumstances is unfair, or leads to sufficient loss to the Exchequer that a change in the law is required. It would not be a surprise, therefore, to see the private residence relief legislation amended in the future and the land approach enacted.

Comment

Clearly, the *Lee* case is a significant victory for the taxpayers. We understand that HMRC will not appeal against it.

Many individuals will now be in a position to reclaim capital gains tax from previous years where the land approach had been adopted. Others may be sitting on a large capital gain which could now be considered fully exempt on sale – although they should note the possibility of a change in legislation.

Some will wonder why HMRC took this case to the Upper Tribunal at all, given that the straightforward textual interpretation was clear.

Finally, the *Lee* case shows again that one should not place too much reliance on HMRC's guidance – the meaning of legislation is always a matter of construction.