

## **CGT and the private residence**

Synopsis: How private residence relief operates together with a consideration of the private residence election where two properties are owned

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### **What is a qualifying residence?**

The private residence relief for capital gains tax (CGT) is (especially in times of substantial increases in value) one of the best known and most valuable property-related reliefs.

The first issue to ascertain is what qualifies as a residence.

The relief given under S222(1) TCGA 1992 applies to the disposal of a dwelling-house or part of a dwelling-house which is, or has at any time in the individual's period of ownership been, their only or main residence. Unfortunately, no definition of "dwelling-house" is contained within the legislation but, generally speaking, any building or structure that could be occupied as a residence would qualify.

It is important to note that, assuming the structure is one that could be a dwelling house, it must also be one at the date of disposal. This means, for example, that a dwelling that was used entirely for business purposes at the date of disposal would not qualify. In practice, however, because of S224(2) TCGA 1992, some apportioned relief to reflect private use may be available.

### **Where the residence comprises a number of buildings**

There have been a number of important cases determining whether, and, if so, the extent to which the relief is available where the dwelling comprises a number of buildings.

In the case of *Lewis v Rook* (1992) STC 171, the issue was how far away from the main dwelling another building could be whilst still qualifying for the relief. In this case the building in question was a cottage.

The taxpayer lost in the "Lewis" case because of the distance the cottage was sited from the main house - 175 metres. There was also the fact that the cottage was separated from the main house by a large garden.

To qualify for private residence relief in respect of a building situated away from the main residence, it is first necessary that the building should be occupied by a member of the taxpayer's own household who is engaged in working for the taxpayer directly – i.e. not for a company owned by him. There are no hard and fast guidelines in respect of the distance that the building must be from the private

residence to qualify. However, it is generally thought that an individual would stand a greater chance of successfully claiming private residence relief if the building is more or less dependent on the main house in terms of its facilities, access and privacy as well as being within a reasonable distance from the main property.

In the 1992 case of *Honour v Norris* STC 304, it was argued that the disposal of one of a number of self-contained flats in different buildings in a London square would qualify for the relief as the taxpayer claimed that, together, all of the buildings constituted his main residence. In this case, the relief was denied. It was decided that the flat in question was a separate dwelling-house and was no more part of a dwelling-house than was, for example, a guest house purchased in a neighbouring village.

The HMRC Capital Gains Manual ([CG64200](#) onwards) provides clarification on the application of the private residence relief.

As regards the meaning of curtilage, *Lewis v Rook* (STC 171) gave guidance on determining whether a building, with one or more ancillary buildings, could together form a single dwelling house for the purposes of Section 222. In cases where there is an identifiable main house, it was held that no building can form part of a dwelling house with the main house unless that building is appurtenant to, and within the curtilage of, the main house.

Curtilage is defined by the Shorter Oxford Dictionary as “a small courtyard or piece of ground, attached to a dwelling-house and forming one enclosure with it”. This definition has been adopted by the Courts in non-tax cases and emphasis is placed on the smallness of the area comprised in the curtilage. Buildings standing around a courtyard together with the main house will be within the curtilage of the main house. Please see [CG64245](#).

### **Which interests in dwelling-houses qualify for relief?**

It is essential that an individual appreciates that the relief is only given for gains arising as a result of the disposal of or an interest in a dwelling-house or part thereof. HMRC has, however, published [Extra-Statutory Concession D33](#) which sets out the various concessions in respect of payments not directly arising from a disposal of an interest in the dwelling-house.

### **Period of ownership and occupation**

The private residence relief is given for ownership and occupation. Full relief is given if the taxpayer, throughout the period of ownership and aside from the last nine months (previously 18 months and historically 36 months), has occupied the dwelling-house as their main residence. This means that if a property is let on an exclusive basis so that the owner cannot actually reside in it, the property cannot in any way constitute a residence for the owner.

Even where access to the residence could be secured by the owner, it may well be that HMRC could argue that, based on the pattern of occupation, the dwelling-house is not in reality a residence within the meaning of the relief. In the cases of *Fox v Stirk* and *Ricketts v Registration Officer for the City of Cambridge*, it was stated that “some assumption of permanence, some degree of continuity, some expectation of continuity, is a vital factor which turns simple occupation into residence”.

The question of how long a taxpayer needs to reside in a property for it to constitute his or her residence has been the focus for a number of tax cases. One case is that of *Goodwin v Curtis* 70 TC 478; (1998) STC 475 heard in the Court of Appeal.

The circumstances are a little complex (not unusual in this sort of case) but, in essence, during the period from March 1985 to December 1985, Mr Goodwin lived in three different properties, all of which were also sold during that period. Initially, HMRC had sought to assess the gains on the disposals as the profits of a trade, but this was eventually rejected by the General Commissioners in favour of CGT. The issue of private residence relief, which had been claimed on all of the disposals, then became significant.

The relief claimed was confirmed by the Commissioners in respect of a house (“Stoneways”) which had been occupied for a little over four months, between the end of July 1985 and early December 1985 when it was sold. It was accepted by the Commissioners (and the Revenue, who did not appeal this part of the decision) that Mr Goodwin had intended to make Stoneways his long-term private residence at the time of acquisition but had been forced by subsequent family considerations to sell it after a very short occupation.

Between 3 May 1985 and 26 July 1985, Mr Goodwin had lived in a small cottage (“Ayton”), the acquisition of which had been intended to provide office facilities for Mr Goodwin’s company. Ayton was small and unsuitable for prolonged private occupation, so Mr Goodwin moved out into Stoneways in July 1985 and finally sold Ayton, in November 1985, for use as offices. His initial occupation of Ayton had not been planned but was forced by circumstances; it had always been intended to use the property for something other than a private residence. The relief claimed on Ayton was refused because of this clear lack of intent, and the Commissioners’ decision was not appealed by Mr Goodwin.

The final property on which relief was claimed was a farmhouse which had been acquired as part of a potential land development arrangement. Mr Goodwin had never intended to live in the farmhouse but was forced to occupy it at the beginning of April 1985 following separation from his wife. He had actually instructed agents to prepare the farmhouse for sale in March 1985, prior to his

completion of the purchase. The farmhouse was sold in May 1985 and Mr Goodwin moved out, into Ayton.

The Court of Appeal confirmed that relief was not due on the sale, notwithstanding Mr Goodwin's occupation of the property. The apparent reason for refusing the relief was not because the property was acquired with the intention of realising a gain from it on disposal (S224(3) TCGA 1992), but because the required degrees of permanence, continuity and expectation of continuity expected of a "residence" were not clearly demonstrated. Thus, the property, whilst a "dwelling-house", did not qualify for relief under S222 TCGA 1992.

One of the key issues, therefore, that determines the availability of private residence relief is the intent of the individual on acquisition. A clear intention to reside permanently in a dwelling-house that is thwarted after even a brief occupation should still give entitlement to the relief. This is evidenced not only by the outcome of Goodwin above but also by more recent tribunal cases such as *Morgan v HMRC* [2013] UKFTT 181 and *Dutton-Forshaw v HMRC* [2015] UKFTT 478 - where the property was occupied for just seven weeks - yet relief was allowed in both cases on the basis of an original intention and expectation of continuing occupancy that was thwarted by unforeseen circumstances. Conversely, even genuine occupation for a reasonable period may fail to attract relief, where it is clear that no continuity of occupation is intended, from the start of ownership.

Since the most significant asset that the majority of people ever own is the property in which they live, it would be useful if the rules regarding this relief from CGT were as clear and unambiguous as possible; especially with the onus to get it right placed upon individuals by self-assessment. Unfortunately, as cases like Mr Goodwin's illustrate, the outcome in any case other than the most straightforward is often difficult to predict with certainty.

### **Land connected with the dwelling-house**

It is relatively well known that private residence relief is available to any land that the owner uses for his own occupation and enjoyment together with the residence. Typically, the land should be its garden or grounds up to a permitted area of 0.5 hectares - see S222(2) TCGA 1992. The key is that, at the date of disposal, if the garden or grounds do not exceed the permitted area and are, as a matter of fact, used as garden or grounds they will automatically qualify for relief. However, even if the ground exceeds this permitted area, relief may still be available under S222(3) TCGA 1992 if the land can be said to be needed for the reasonable enjoyment of the dwelling-house as a residence.

Clearly, the larger and more "imposing" the dwelling-house, the more likely is a large area of land to be allowed. Where part of the land occupied by the residence falls within the exemption and part outside of it S222(4) TCGA 1992 provides for a statutory apportionment of the relief.

In order to qualify for relief in respect of any disposal of land alone, the land should be disposed of at a time when the private residence (i.e. the dwelling-house) is still in the ownership of the taxpayer. In practice, it has proved difficult to secure relief for any gains arising on a disposal of part of the land if the whole of the land exceeds the permitted area of 0.5 of a hectare. The argument runs that relief is only available for areas in excess of the permitted area if the land is necessary for the enjoyment of the dwelling-house. If a part of the land is being sold and the dwelling-house is being maintained, then it is hard to sustain an argument that there is such a necessity. This problem should not, of course, arise where there is a disposal of part or all of the land where the total holding is less than the permitted area.

The leading case covering the sale of the land after the private residence has been sold is that of *Varty v Lynes* 51 TC 419. In that case, it was held that the relief in respect of the garden was not available where it was not enjoyed with the dwelling-house at the time of the disposal.

HMRC gave further clarification on this issue ([CG64200](#) onwards). Here it stated “*Varty v Lynes* (51 TC 419)” established that no private residence relief was due on the sale of a garden where it was sold separately and after the dwelling-house.

### **Ownership conditions**

It is most important to understand that all periods of ownership before 31 March 1982 are excluded from consideration of the extent to which private residence relief is available to any particular taxpayer. This provision, set out in S223(7) TCGA 1992, means that, if an individual had a period of ownership where he was not in residence before 31 March 1982, this will not have any adverse impact on the availability of the private residence relief.

A delay in taking up occupation of a dwelling-house as a residence at the start of a period of ownership is permitted. [For disposals before 6 April 2020, this was set out in [Extra-Statutory Concession D49](#).]

Broadly speaking, relief is given up to the first 12 months of ownership even if the taxpayer has not resided in the dwelling-house due to the fact that he had bought land and the house has not yet been constructed or where the taxpayer bought an existing house and before moving in arranges for alteration, redecoration or is attempting to dispose of his previous residence. The allowable 12 month period may be extended for another 12 months to two years, provided there is a good reason for so doing.

At the other end of the ownership period there is relief in respect of the last nine months of ownership so that even if the taxpayer does not reside in the property for a period of up to nine months ending with the disposal of the property that

period will still be treated as a period of ownership for the purposes of calculating the relief.

Having taken into account (where appropriate) the concession for any delay in taking up residence and a qualifying period of non-residence pre-disposal, it may then be necessary to apportion the gain into so much that is eligible for relief and the remainder that isn't.

In making this apportionment, HMRC, as well as the concessions operating at the beginning and the end of a period of ownership, will also permit certain periods of absence to be treated as periods of residence in the calculation. Under S223(3) TCGA 1992, it is provided that the following periods will be treated as periods of occupation for the purposes of private residence relief...

- A period or periods not exceeding, in total, three years; and
- any period throughout which the taxpayer was employed and worked outside the UK or throughout which the individual lived with a spouse or civil partner who worked in such office or employment; and
- any period or periods not exceeding in total four years throughout which the taxpayer could not reside in the property in consequence either of the situation of their place of work or of any condition imposed by their employer requiring the taxpayer to reside elsewhere (being a condition reasonably imposed to secure the effective performance by the employee of their duties),

...provided that before and after that period there was a time when the dwelling-house was the taxpayer's main residence.

It should be noted that these periods are cumulative so that, for example, a period of absence from the property in the UK for up to three years could then be followed by a period of working abroad.

It is, however, important to note that for all of the permitted periods of absence to be available it is necessary for the property, as a matter of fact, to be the only or main residence of the taxpayer. It is also necessary for the taxpayer, throughout the period of absence, to have no other residence or main residence eligible for the relief under S223.

Having taken into account all of these factors, one can then make an apportionment if this is appropriate. Of course, for the vast majority of taxpayers in the UK, there will be no need to do this as the property will have been the private residence throughout the period of ownership. Where, however, an apportionment is to be made it will be made as explained above.

### *Job-related accommodation*

If an individual lives in accommodation that is job-related and they also own a dwelling house that they intend to occupy as their only or main residence, the dwelling house they intend to occupy is treated as actually being occupied by them as a residence during the period in which they intend to occupy it, even if they never actually live there. This means that they may nominate that residence as their only or main residence and get relief on the whole or a part of the gain. If their intention to live in the dwelling house ends, then the dwelling house is no longer treated as their residence.

Accommodation is job-related if it is exempt from income tax for the reasons set out in [Helpsheet 202 Living accommodation](#). This extension of private residence relief also applies if an individual is self-employed. The job-related accommodation must be provided by another person under the terms of a contract that requires them to live in the property and carry on a particular trade.

### **Anti-avoidance**

The fact that anti-avoidance provisions exist in respect of the private residence relief is often forgotten. However, there is, in effect, a “motive test” to be satisfied before the relief is available. S224(3) TCGA 1992 in effect disapplies the Section 223 relief where the acquisition of a dwelling-house is made wholly or partly for the purpose of realising a gain from the disposal of it.

It seems that in practice HMRC will apply these provisions in only the most “obvious” cases. Particular application of the provisions can be seen in cases involving developers including cases where property is bought and then converted into flats or other conversions. In these cases there is a risk that the profit will be treated as trading income. Please see [CG65200](#) onwards.

### **Disposals by personal representatives in accordance with the deceased’s Will**

For disposals on or after 10 December 2003, Section 225A TCGA provides that private residence relief is available in relation to gains arising to the personal representatives of a deceased person on the disposal of a property provided that two conditions are satisfied as follows...

- firstly, immediately before and immediately after the death of the deceased person, one or more individuals have occupied the property concerned as their only or main residence, and...
- that individual or individuals is, or are between them, entitled as legatee(s) of the deceased person in question to at least 75% of the net proceeds of disposal, or to an interest in possession in 75% or more of those proceeds.

Where there is more than one individual who occupied the property as their only or main residence, the 75% condition is tested by accumulating the separate interests of all the individuals concerned: it is not necessary for all the individuals in question to have such an interest for the condition to be met.

“Legatee” includes any person whose entitlement results from the will or intestacy (or partial intestacy) of the deceased person.

For this purpose, the “net proceeds of disposal” are the proceeds of the disposal realised by the personal representatives, less any incidental costs of disposal allowable as a deduction under Section 38(1)(c) TCGA 1992 in computing any capital gain arising to the personal representatives on that disposal. In testing whether the 75% condition is satisfied, the assumption is made that none of the proceeds of the disposal are applied to pay inheritance tax (IHT) or to meet any other liabilities of the deceased person’s estate.

For disposals prior to 10 December 2003, relief was available to personal representatives for any gains arising on the disposal of a private residence by the personal representatives under the Will of the deceased under Extra-Statutory Concession D5. FA 2004 introduced new provisions in TCGA92/S225A which give statutory effect to ESCD5. Please see [CG65460](#).

### **Disposals by beneficiaries**

Where there is a disposal by a beneficiary of an inherited property the combined effect of Section 62(4) and Section 222(7) is that the beneficiary’s period of ownership begins on the date of death. Where the beneficiary does not become resident until a later date, the period prior to taking up occupation will not qualify for relief (unless it falls within the final nine-month period prior to disposal (Section 223(2))).

### **Principal private election where an individual owns more than one residence**

#### **General rule**

The relief available in respect of gains made on a disposal of a private residence is available for the disposal of the taxpayer’s “only or main residence”. S222(5)(a) TCGA 1992 provides that where for any period a taxpayer has more than one residence an election can be made that determines which residence is the main residence of the individual for CGT purposes. It is, however, essential that any property that is so elected to be the private residence is in fact a residence. Thus, property that is rented and from which an individual owner is in fact excluded would not qualify as a residence.

It is important to note that there is a strict time limit during which the taxpayer can make an effective election. This has been confirmed in the case of *Griffin v Craig-Harvey* (1994) STC 54. S222(5)(a) TCGA 1992 provides that the election must be made within two years of acquiring the second property. Section 222(5)(a) extends the two-year period if the interest in one or more properties to be used as a residence has negligible value and the taxpayer was unaware that a nomination could be made.

Once the taxpayer becomes so aware, the election must be made within a reasonable time. However, the *Craig-Harvey* case upheld HMRC's view that the two-year period for electing runs from the date on which the taxpayer starts to use the second property as a residence, not from the date they acquired the property. Any notice of election that has been given can be varied by a further notice in writing provided, however, that the period covered by the further notice cannot begin earlier than two years before the date of the further notice.

### **Combining the rules for electing which of two properties is the taxpayer's residence for the purposes of relief with the extension of relief for the last nine months of ownership**

In general, private residence relief applies to the period during which the taxpayer has occupied the property in question as a residence. But, in order to help people who have difficulty in selling a house when they move, the tax rules state that the last nine months of ownership count as a period of residence even though the owner may not have been living there then.

#### **Example**

Jock, a higher rate taxpayer, bought his home in Surrey in May 2018. In May 2026 he buys a house in Scunthorpe and goes and lives there leaving the Surrey property empty. He struggles to sell the Surrey property but eventually does so in May 2029, i.e. after three years. He sells at a profit of £100,000.

Jock has owned the Surrey property for 11 years – so 132 months - eight years and nine months of which count for private residence relief – so 105 months. This is because Jock can add nine months of continuing ownership (but non-occupation) to the eight years of actual occupation. This means that 105/132 of the gain is exempt from CGT, so £79,545 and £20,455 is taxable. After deducting his annual exemption of £3,000, the residual taxable capital gain is £17,455 on which CGT at 24% produces a tax bill of £4,189.20.

The availability of the nine months ownership period can be particularly useful for those people who have two private residences. It provides a way in which a person can secure some relief with only a relatively short period of residence. Please see [CG64510](#).

### **Some questions that may be asked in connection with main residence elections**

#### **(i) Do you have to spend the most time in the property chosen as your residence?**

No – you can elect either of two residences provided you actually do use both as a residence. As proof, you have to show utility, bank or electoral details. The residence you choose must be available as a residence.

#### **(ii) Is there any time period during which you must make the election when you own two properties?**

It is generally stated that you must elect your main residence within two years of acquiring the second property. In fact, that is not the case – you must elect within two years of **using the second property as a residence**. This means that if you buy a property, let it out for three years and then start occupying as a residence you have two years from that commenced date of occupation to make the election. In general, if you do not elect within two years of acquiring a second property, HMRC will make this decision for you based on the facts.

The acquisition of a third property would re-open the two-year window to make an election.

#### **(iii) Does it matter that a property has previously been let?**

No – please see above. But you must at some stage occupy it for a reasonable period as a residence.

#### **(iv) Married couples/civil partners elect for different properties?**

No, they must have the same residence. However, unmarried couples (and unregistered civil partners) can each elect for their own private residence.

#### **(v) Can you switch the election between properties?**

Provided you make the first election within two years of occupying the second property as a residence, you can switch (flip) between different properties as much as you like, provided you do, in fact, then occupy the newly elected property as a residence.

### **Some planning ideas with respect to the private residence election where two properties are owned**

The general rule in a time when house prices are rising is that it is usually advantageous to elect for the property with the higher value to be treated as the main residence on the assumption that this property would show the largest gain. It

is, when making an election, essential to remember that HMRC would not normally accept an election after two years have expired from the acquisition of the property. Any election can be varied retrospectively for up to two years and it is therefore possible to change the election for a short period to take advantage of the relief for the last nine months of ownership.

Where an election is to be made by a married couple/civil partners, it is essential that they both sign the election. An election will be invalid if it affects both of them, but is signed by only one of them.

An opportunity to start a new two-year period may be for the taxpayer to acquire a third property. On the acquisition of the property, the taxpayer will be able to elect between the residences (including those which they own already) as to which one should be their private residence.

Another planning opportunity may arise for taxpayers who are posted abroad for some time. If that individual, whilst overseas, has accommodation abroad, say in the form of rented property or property provided free by an employer, it is possible that that accommodation, as a matter of fact, may become the client's main residence. The overseas property would be treated as the individual's main residence if it is borne out as a matter of fact.

In this case, absence from the UK property would not qualify as a "permitted period of absence" under S223(3) TCGA 1992. This is because, in order to qualify for the permitted period of absence, one of the main conditions is that during the period of absence the taxpayer must not have any other property qualifying as their only or main residence, which has a negligible value, which is likely. It would seem that an election could be made if, indeed, as a matter of fact the client could be said to have another residence abroad. Whether an election could be made in respect of the UK property, however, would of course depend on it actually being a "residence". If it were let this may well be difficult.

### **Married couples/civil partners**

The basic CGT provision in respect of a married couple (and civil partners) is well set down in Section 58 TCGA 1992. Broadly speaking, this provision provides that where in any year of assessment the couple are living together and either of them disposes of assets to each other then they are both treated as if the asset was acquired from the other at the original acquisition cost – this means that at the time of disposal neither a gain nor a loss would accrue to the one making the disposal. This means, of course, that for most transfers between married couples/civil partners there would be no chargeable gain arising.

It is, however, important that, in order to make use of this relief, the couple must be living together in that year of assessment. The couple would be treated as living together unless they are separated under an order of a court of competent

jurisdiction, or by deed of separation, or they are in fact separated in such circumstances that the separation is likely to be permanent.

Where the test is failed, a transfer between married couples/civil partners would be a disposal for the purposes of CGT.

However, there are some important changes regarding couples that are separating, in relation to disposals that occur on or after 6 April 2023. For disposals that occur on or after 6 April 2023...

- separating spouses or civil partners are given up to three years after the year they cease to live together in which to make no gain or no loss transfers;
- no gain or no loss treatment will also apply to assets that separating spouses or civil partners transfer between themselves as part of a formal divorce agreement.

At worst, even though they may have physically separated, they are still likely to be treated as connected with each other so that market value will be used to determine the amount involved in any disposal between them. This connection will apparently remain until up to the issue of the decree absolute.

Married couples and civil partners are entitled to the private residence relief in respect of only one property between them. Compare this with the situation of an unmarried couple who, with two properties, may each elect that one of the properties should be their private residence - assuming of course that the property elected is capable of being a "residence".

In many separations and divorces, it is not unusual for one party to leave the matrimonial home even though they still maintain an interest in it. This position could indeed continue for many years - and during those years there may be a possibility of reconciliation. The nine months "end of ownership" provision may help if at a time not beyond the end of the nine-month period the property of the person who is not using it as a residence is sold. However, where this position continues beyond nine months, this could give rise to problems.

Section 225(B) provides that where a couple separate and one partner ceases to occupy the matrimonial home and subsequently, as part of a financial settlement, disposes of the home or an interest in it to the other partner, the home may be regarded for the purposes of the CGT relief as continuing to be the residence of the transferring partner from the date that his or her occupation ceases to the date of the transfer provided that it has been throughout this period the other partner's only or main residence. This will only operate, however, where the interest in the property is transferred from one partner to the other partner and the transferring

partner has not elected during their period of absence for some other house to be their main residence.

Where there is a sale following divorce, the couple having remained in physical occupation until sale, then private residence relief will usually be available. Where this is not the case, i.e. one party leaves the home but retains an interest, the position is a little more complex because any gain made on sale outside of the nine-month period would be chargeable to CGT.

However, in relation to disposals that occur on or after 6 April 2023...

- a spouse or civil partner who retains an interest in the former matrimonial home is given an option to claim Private Residence Relief (PRR) when it is sold;
- individuals who have transferred their interest in the former matrimonial home to their ex-spouse or civil partner and are entitled to receive a percentage of the proceeds when that home is eventually sold, will be able to apply the same tax treatment to those proceeds when received that applied when they transferred their original interest in the home to their ex-spouse or civil partner.

### **Rented property**

Rented property is not eligible for relief from CGT. However, careful planning can reduce any tax charge that may arise. Buy-to-let has been popular in recent years as a form of investment. With house prices rising there are many sitting on substantial gains. When the property is sold the owner could face a large tax bill. So, what can be done to reduce this prospective tax bill?

- Live in the property. If the owner has lived in the property as their only or main residence at any time, the gain referable to the last nine months of ownership is free from CGT. If the property was owned for a total of four years but the owner only lived there for the first two years then two years nine months would be covered by the exemption. Further, up to £40,000 of any gain not qualifying for private residence relief could historically be relieved through "lettings relief". [But note that letting relief only applies to those who have lived in the property at some time. For disposals taking place after 6 April 2020, "lettings relief" will only be available for periods where the owner shares occupation with a tenant(s).
- Transfer part of the property to a spouse/civil partner. This will allow them to use their annual exempt amount, as well as the original owner's. Additionally, any gain on the transferee's share that exceeds the annual exempt amount will be taxed at that person's tax rate(s) and not the original

owner's. The transferee spouse/civil partner may be paying tax at a lower rate than the transferor spouse/civil partner.

- Keep all records of the cost of home improvements as these can be added to the cost when calculating the capital gain.

### **Interaction of hold over relief and principal private residence relief - Finance Act 2004 changes**

CGT hold-over relief is a useful relief for somebody who wishes to gift assets without an immediate CGT liability. By making the gift into a discretionary trust and so triggering an IHT lifetime chargeable transfer, it is possible to avoid immediate CGT by claiming hold-over relief – this defers tax on the gain until the trustees subsequently realise the asset. Of course, by keeping the size of the gift within the donor's available nil rate band, no immediate IHT will arise.

The Government believed that the ability to use hold-over relief on gifts (including those to discretionary trusts) was being abused for tax avoidance purposes in two ways and, as a consequence, announced legislation effective from 10 December 2003 to combat the use of such schemes. Details of the two changes are as follows...

- Provisions were introduced to prevent people using trusts to exploit the interaction between private residence relief and hold-over relief with a view to avoiding CGT. The main purpose of these provisions is to counter tax avoidance schemes which are designed to secure that gains arising on the disposal of properties that are not the main residence of hold-over relief (gifts) under either Section 165 (gifts of business assets) or Section 260 (gifts to discretionary trusts) of the Taxation of Chargeable Gains Act 1992 (TCGA) being the settlor are able to benefit from private residence relief.
- Provisions prevent the availability of hold-over relief in respect of transfers of assets, including residential property, to the trustees of settlor-interested settlements if certain conditions are satisfied.

The relevant legislation can be found in Sections 116 and 117 and Schedules 21 and 22 of Finance Act 2004. Each of these provisions is looked at in detail below.

#### **(i) Hold-over relief and private residence relief**

Trustees of a trust are entitled to CGT private residence relief on the sale of a property that has been used by a beneficiary as their only or main residence. This would enable a person to make a gift of a second residential property to a discretionary trust under which they (as settlor) were included as a potential beneficiary. Provided one of the beneficiaries under the trust occupies the property as a sole or main residence then, on a subsequent sale of the property, there would be no CGT on all capital gains – including any held-over gains. The proceeds of

sale, free of CGT, could then be distributed by the trustees to the settlor who is one of the potential beneficiaries.

The effect of the FA2004 provisions is that private residence relief is not available in certain circumstances where the disposal in question is made on or after 10 December 2003 by an individual or the trustees of a settlement. These circumstances arise where the computation of the amount of any gain arising on the later disposal by the trustees has to take account of hold-over gifts relief obtained under Section 260 of the TCGA in respect of an earlier disposal. This is subject to a transitional provision, which restricts the amount of private residence relief available if the earlier disposal concerned was made before 10 December 2003. If there was more than one relevant earlier disposal the transitional provision applies only if all those earlier disposals were made before that date.

These provisions do not apply in any case where the gain arising on the disposal is not in any way affected by a gift relief claim under Section 260 of the TCGA in respect of an earlier disposal into the trust.

*Example of how the new rules operate – Jill...*

### **Pre 10 December 2003 rules**

Jill owns a house which is not her only or main residence. It has a market value of £250,000 and if she were to sell it a chargeable gain of £150,000 would arise to her on the disposal. She wants to sell the house and give the proceeds to her children, Sandra and Paul.

She transfers the house to the trustees of a discretionary trust. She claims hold-over gift relief. If the settlement is a settlor-interested settlement, the legislation would prevent her from claiming hold-over gift relief. But the settlement is drawn up so that Jill does not have and may not acquire such an interest. The beneficiaries are Sandra and Paul. So, Jill claims hold-over gift relief and the gain is held over.

The terms of the settlement permit the trustees to allow certain persons to occupy the house. The trustees allow Paul to do so, and he occupies the house as his only residence.

After a few months, Paul vacates the house and the trustees sell it within a further few months for a sum (net of expenses) of £270,000. A chargeable gain of £170,000 (most of which is effectively the held-over gain) arises to them. However, this gain is not chargeable to CGT because the trustees benefit from private residence relief. The trustees can then distribute the sale proceeds to Sandra and Paul.

The full value of the house has thus been transferred from Jill to Sandra and Paul without any CGT being paid.

### **Post 9 December 2003 rules**

The provisions counter schemes of this nature. Where a house is transferred, either the transferor can benefit from hold-over gift relief under section 260 or the recipient can benefit from private residence relief on a subsequent sale of the house. It will no longer be possible for both reliefs to apply.

So, in the example of Jill above, if Jill claimed hold-over gift relief under section 260, the trustees' gain of £170,000 on the sale of the house would not be covered by hold-over gift relief and they would be liable to CGT on that gain. Alternatively, if Jill did not claim hold-over gift relief on the transfer of the house to the trustees, she would be chargeable to CGT on her gain of £150,000. The trustees' gain on the sale of the house would be reduced to £20,000, which could be covered by private residence relief.

A problem can, however, arise. Because of the time limits for making claims, it is possible that the recipient of the transfer has sold the house and accounted for the gain before the claim for hold-over gift relief is made. Suppose that Jill did not make a claim for hold-over gift relief before the trustees sold the house. As there had at that time been no claim for hold-over gift relief, there would have been no held-over gain to affect the computation of the trustees' gain, which would be £20,000 (proceeds £270,000 less acquisition value £250,000). They would be entitled to claim private residence relief and therefore would not be chargeable on that gain. But if Jill then made a claim for hold-over gift relief within the statutory time limit, her claim would be valid and she would be entitled to the relief.

In that situation, the legislation provides that the trustees' gain should be recomputed. Because of the claim to hold-over gift relief, the trustees now have a gain of £170,000 (effectively including Jill's held-over gain of £150,000) and, because Jill had claimed hold-over relief, they would not be entitled to private residence relief. So, they would be assessed on a gain of £170,000.

### **(ii) Hold-over relief and "settlor-interested" trusts**

This facility to defer liability to tax on a gain by claiming hold-over gift relief has been widely exploited for tax avoidance purposes in schemes involving the transfer of assets to settlor-interested settlements. The trustees dispose of the transferred asset but, typically, arrange matters in such a way that the chargeable gain is eliminated or reduced.

This can, for example, be achieved by the trustees having or creating allowable losses that can be deducted from the chargeable gain. Or, as a further example, tax reliefs may be exploited by the trust to eliminate the chargeable gain. A key feature of all these schemes is that because an individual who is a settlor in relation to the settlement has an interest in the settlement, he has access to the proceeds from the trustees' disposal of the transferred asset. These provisions therefore prevent

CGT hold-over gift relief being available on gifts to trusts under which the settlor is a potential beneficiary.

*Example 2 – Louise...*

### **The pre 10 December 2003 position**

Louise owns a house which is not her only or main residence. It has a market value of £250,000 and if she were to sell it a chargeable gain of £150,000 would arise to her on the disposal.

She transfers the house to the trustees of a settlement in which she has an interest. She claims hold-over gift relief and the gain is held over.

The terms of the settlement permit the trustees to allow certain persons to occupy the house. The trustees allow Alan, Louise's son, to do so. Alan then occupies the house as his only residence.

After a few months, Alan ceases to occupy the house and the trustees sell it for a sum (net of expenses) of £250,000. A chargeable gain of £150,000 (effectively the held-over gain) accrues to them. However, this gain is not chargeable to CGT because of provisions that allow trustees to benefit from the relief for gains arising on the disposal of private residences if a house has been occupied, under the terms of the trust, by a beneficiary as that person's only or main residence.

The trustees are left with full proceeds of the sale. And Louise has access to those proceeds, because she has an interest in the settlement.

### **The post 9 December 2003 position**

These provisions stop hold-over gift relief from being available on transfers to the trustees of settlor-interested settlements. So, if Louise transferred the house to the trust on or after 10 December 2003, she would not be able to claim hold-over gift relief and a chargeable gain of £150,000 would arise to her. The disposal by the trustees would not give rise to any gain or loss, because the value of the property when they acquired it from Louise, £250,000, is deducted from the sale proceeds of £250,000 when computing any gain or loss on the disposal.

The second element of these provisions prevents people circumventing the bar on hold-over gift relief on transfers to settlor-interested settlements by transferring an asset to a settlement that was not a settlor-interested settlement at the time of the disposal, and subsequently acquiring an interest in that settlement. If hold-over gift relief is obtained in relation to the transfer of an asset to a settlement, and at some future time no later than six years after the end of the tax year in which the gift was made the settlement becomes a settlor-interested settlement, the hold-over gift relief is "clawed back" under special provisions that exist.

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