

Trading from home

KEVIN SLEVIN considers the interaction of two valuable capital gains tax reliefs: main residence and entrepreneurs' relief.

Capital gains tax applies to chargeable gains computed in accordance with TCGA 1992, s 1 and all future references are to this Act. Where s 222 applies, all or part of the gain arising to an individual on a disposal of either:

- (i) a dwelling house which has been used at some time during his ownership as his only or main residence; or
- (ii) land which he has held for his occupation and enjoyment with the dwelling house in (i) above as its garden or grounds (up to the permitted area);

is to be treated as *not* being chargeable. Section 222 has the effect of excluding from the figure of the chargeable gains arising so much of the capital gain on the disposals falling within (i) or (ii) above as is determined by s 223.

Due to the operation of s 222 (including the restrictions found in s 224), circumstances frequently arise where part of a gain arising on a property disposal falls to be treated as non-chargeable and the remainder remains as a chargeable gain liable to capital gains tax.

This article focuses on situations where not only is part of a capital gain arising on a disposal non-chargeable under s 222, but the taxpayer also wishes to claim the benefit of the entrepreneurs' relief (s 169H to s 169S) and enjoy the 10% rate of capital gains tax. These reliefs are, without doubt, the two most important tax reliefs for individuals.

The interaction between them is far from straightforward where a businessman's home has also become his place of business and this article demonstrates some of the issues which need to be addressed. Due to the restrictions of space, in the



comments which follow, readers are assumed to have a good grasp of the principles of these two reliefs. The potential for using rollover or other reliefs may, of course, also exist, but for the sake of simplicity and space they do not feature in this article.

The sequence of events

Before exploring the issues which can arise under each of these situations in turn, it is necessary to consider the order of priority as regards the two reliefs, i.e. which is to be taken into account first.

As explained in the introduction above, the relief available to a taxpayer because a dwelling house has been occupied by him as his only or main residence exempts the appropriate part of the otherwise chargeable gain.

Contrast this with the impact of entrepreneurs' relief which essentially relates to gains arising as a consequence of disposing of an interest in a business. Here, the taxpayer must choose whether or not he wishes to make a claim to take advantage of the relief. Where a claim is made, the chargeable gain (or some part of it) becomes taxable at 10% rather than the full rate of 28%.

I therefore consider that the sequence of events is first to establish the chargeable gain. Having established the chargeable gain, i.e. as reduced by the exemption contained in s 222 and s 223 (but before taking into account the £10,600 annual exempt amount), the taxpayer can then explore what proportion of the chargeable gain, if any, is taxed at the reduced capital gains tax rate of 10% found in s 169N.

If part of the chargeable gain is taxed at 28% and part is at the 10% rate the next decision is to apply s 4B(2) so that the annual exempt amount (AEA) can be applied first so as to reduce the amount of gain taxable at 28%. Any balance of the AEA relieves the gain to be charged at the 10% entrepreneurs' relief rate.

KEY POINTS

- The priority between main residence and entrepreneurs' relief.
- Using part of the main residence exclusively for business purposes.
- Is there a cessation of the business when the property is disposed of?
- The effects of joint property ownership.
- Some unexpected results of the interaction of the two reliefs.

STEPHEN 1

Stephen has run his veterinary practice from his sole residence for the ten years since acquiring the property. He is retiring and selling both his home and business to his assistant. It has been calculated that, as regards the disposal of the residence, of Stephen's capital gain of £400,000, £100,000 will be left in charge due to the restriction found in s 224(1), applicable because of the exclusive use of part of the property. Stephen's chargeable gain as regards the disposal of the goodwill of his business has been calculated at £200,000.

Accordingly, Stephen's capital gains tax position becomes:

	£
Gain on disposal of residence	100,000
Gain on disposal of goodwill	<u>200,000</u>
Total	300,000
Less AEA	<u>10,600</u>
Assessable at 10%	<u>289,400</u>
Capital gains tax	28,940

STEPHEN 2

Stephen does not start to run his veterinary practice from his sole residence until one year after acquiring and occupying the property. The gain relating to the whole property for the first and final three years of the ten-year period of ownership is therefore exempt. The position otherwise is as in **Example 1** and both the home and business are being sold to Stephen's assistant.

The assessable gain on the business element of the property therefore falls from £100,000 to £60,000 and Stephen's capital gains tax position becomes:

	£
Gain on disposal of residence	60,000
Gain on disposal of goodwill	<u>200,000</u>
Total	260,000
Less AEA	<u>10,600</u>
Assessable at 10%	<u>249,400</u>
Tax	24,940

Trading from home

A sole trader may dispose of his dwelling house in circumstances where s 222 and s 223 reduce his otherwise chargeable gain but, because of the business use of the property in question, a residue of the gain is left in charge (see s 224). If we assume that, in the absence of the entrepreneurs' relief provisions, the residue of the gain is subject to tax at the 28% rate, the question is just when – and if so, how – the 10% entrepreneurs' relief rate can be applied.

The position is best demonstrated by examples, but when considering these it is important not to lose sight of the fact that a sole trader may only claim entrepreneurs' relief in respect of a gain which arises on the disposal of a relevant business asset (s 169L) which is linked to, or takes place as part of, a disposal of all or part of a business. Gains arising on isolated disposals of business assets will *not* attract relief. Thus if, in **Stephen 1**, all that was envisaged was a sale by Stephen of the dwelling house from which he trades (with him simply relocating his business to another property) the 28% rate will be applied to the £100,000 gain assessable. Doubters of this fact need only turn to the case of *McGregor v Adcock* [1977] STC 206. Contrast **Vets Ltd** where Stephen is disposing of his place of residence after having technically ceased to run his sole tradership business (less than three years prior to the property sale) when entrepreneurs' relief may well be claimed.

In **Stephen 1**, Stephen will be able to show that he is disposing of 100% of his business and that the property disposal falls within s 169I(1), (2) and (3); in other words, he will be able to demonstrate that he is making a material disposal of business assets. Furthermore, he will satisfy the conditions in s 169L because he will be able to show that both the gain on the goodwill and the gain on the chargeable dwelling house are gains arising on 'relevant business assets' within s 169L. To show that he has met the requirements of s 169L Stephen merely has to demonstrate that each asset disposed of is an 'asset used for the purposes of' the business carried on by him at the point the business ceases to be carried on by him – as is the

case in the example. There is no requirement to be found in the entrepreneurs' relief provisions for the asset to be used totally for the purposes of the business.

In **Stephen 2**, the facts are similar to those in **Stephen 1** except that Stephen initially occupied the whole of the property as his sole residence for the first year of ownership. Thus, irrespective of the subsequent exclusive business use of part of the property, the entire gain attributable to the final 36 months of ownership – not just that relating to the part which is occupied as a residence – must be excluded from being a chargeable gain (under s 223(2)). This reduces Stephen's assessable gain regarding the area used in his business by 4/10ths (i.e. the initial year plus the last 36 months being exempt) and so Stephen's assessable gain on the property falls from £100,000 to £60,000.

“ There is no requirement to be found in the entrepreneurs' relief provisions for the asset to be used totally for the purposes of the business. ”

In **Vets Ltd** the facts of **Stephen 1** are changed to a different scenario. First, it is now to be assumed that Stephen took tax planning advice when initially contemplating the sale of his dwelling house and, as a result, his business was transferred to a limited company – Vets Ltd – with effect from 1 January 2011. Vets Ltd has paid a full market rent to Stephen in order to occupy part of his house.

A further change made to the facts in **Stephen 1** is that in **Vets Ltd** there is no intention to dispose of any part of his interest in the business yet there is still an opportunity for Stephen to benefit from entrepreneurs' relief.

VETS LTD

Here the facts are similar to those in *Stephen 1* except that Stephen is assumed to have transferred his continuing business to Vets Ltd on 1 January 2011 and that he has no plans to dispose of his shares. Since that date, Stephen has been in receipt of a full market rent from the company. Assume Stephen was paid for his goodwill by the company and capital gains tax paid at the 10% rate on the disposal of the business.

On 22 December 2013, Stephen completes a contract to sell his family home (securing that Vets Ltd vacates so as to give the new owner vacant possession). Vets Ltd moves into rented premises owned by an unconnected landlord.

Still assuming Stephen's chargeable capital gain – i.e. after reduction to reflect the private residence exemption under s 222/s 223 – to be £100,000, the question to be determined is what rate of tax applies.

In these circumstances, Stephen can show that the £100,000 chargeable capital gain arising on the disposal of the dwelling house falls within s 169I(2)(b)(4). That is to say, the gain arises on a disposal of an asset which was in use in the business carried on by Stephen at the time he ceased to do so (i.e. at the date of incorporation) and that the property was disposed of not more than three years after the business was disposed of by him to Vets Ltd.

Accordingly, Stephen's capital gains tax position becomes:

	£
Gain on disposal of residence	100,000
Less AEA	<u>10,600</u>
Assessable at 10%	<u>89,400</u>
Tax	8,940

It will be noted above that the fact that rent was paid to Stephen by Vets Ltd for the period from 1 January 2011 until the disposal of the property on 22 December 2013 does not impact on the availability of entrepreneurs' relief. It should also be noted that, in this example, if the property disposal should take place after 1 January 2014, that is more than three years after the cessation date, entrepreneurs' relief would not be available and, therefore, the tax payable on the chargeable gain would be increased by 180% to £25,032.00 (i.e. increased to 28% of £89,400).

The permitted area

The examples so far assume that the capital gains tax exemption applicable to the gardens or grounds of the property is not restricted under the maximum permitted area rule to be found in a 222(2), (3) and (4).

An interesting anomaly appears to operate where there is mixed residential and business use of a dwelling and the permitted area rule operates so as to constrain the amount of the main residence exemption arising from the use of the property as the taxpayer's sole or main residence.

Let us assume that Stephen wishes to retain the business, but that he receives a substantial offer from a possible

PROPERTY SALE

Calculation of chargeable gain.

	£
Gain attributed to dwelling house and permitted area of land	2,000,000
Proportion of £2,000,000 gain attributed to residential use	<u>1,400,000</u>
Chargeable gain re business use of dwelling house	600,000
Gain attributable to area of land falling outside the exempt permitted area (and having no business use at any time)	<u>1,000,000</u>
Total chargeable gain on disposal	1,600,000
Less AEA	<u>10,600</u>
Assessable at 10%	<u>1,589,400</u>
Tax	158,940

purchaser of his residence – a property which not only comprises the dwelling house, but also 2.75 acres of land ripe for development. Stephen's property adviser points out that his land is the key to development of an adjoining seven-acre site (over which the potential buyer already possess options to acquire) and he has therefore negotiated a substantial premium.

After living and working there for ten years, Stephen is minded to sell the property and his adviser has calculated that he will make an overall capital gain (before the main residence exemption) of £3,000,000 which can be analysed as shown in *Property sale*. Recognising the fact that a simple asset sale will not by itself attract entrepreneurs' relief, Stephen's tax adviser suggests that the property should either be disposed of on the same date that he disposes of his business to a company or, more likely, that he arranges to transfer to a limited company on a date not more than three years prior to the date of disposal of the property. In this way the property disposal is structured as a post-cessation transaction taking place within the three-year period found in s 169I(4). If the latter route is followed, this gives more flexibility as Stephen can choose to incorporate when the actual disposal date of the land is becoming clear. With buyers routinely seeking options or conditional contracts, careful consideration needs to be given to the exact sequence of events and the management of them.

If we assume that the desired planning permission is granted and that this triggers a disposal of the entire property – i.e. dwelling house and land is sold as a single asset – we must also assume that the appropriate tax planning steps have been put in place which result in Stephen being able to claim entrepreneurs' relief on the chargeable gain attributable to both the area of the house used exclusively for business and the area of land not used in the business and being gardens situated outside the permitted area. The question which arises is how much of the gain will be taxable at 10% and how much at the full rate of 28%?

Providing the disposal of the dwelling is structured as suggested so as to fall within s 169 – so that the

STEPHEN AND MARY

Here we assume that Stephen and his wife Mary have equal beneficial interests in the dwelling house they have lived in for ten years and from which Stephen has run his business.

Here, only Stephen's gains can attract entrepreneurs' relief and accordingly, Stephen's capital gains tax position becomes:

	£
Gain on disposal of residence	50,000
Gain on disposal of goodwill	<u>200,000</u>
Total	250,000
Less AEA	10,600
Assessable at 10%	<u>239,400</u>
Tax	23,940

Mary's CGT position will be:

	£
Gain on disposal of residence	50,000
Gain on disposal of goodwill	-
Total	50,000
Less AEA	10,600
Assessable at 28%	<u>39,400</u>
Tax	11,032

This example reflects an overall increase in tax of £6,032.00. The result can be summarised as follows:

	£
Tax no longer payable by husband on 50% of chargeable gain on dwelling now attributed to wife	5,000.00
Tax to be paid by wife on her 50% share of gain (as above)	<u>11,032.00</u>
Increase	<u>6,032.00</u>

property disposal either takes place at the same time as the incorporation or not more than three years following the cessation of the business due to its incorporation and it can be shown that part of the property was in use in the business immediately before incorporation thereof, the 10% entrepreneurs' relief rate will apply to the entire assessable gain and accordingly, Stephen's capital gains tax position becomes as shown in **Property sale**.

In the author's view, even though no part of the chargeable gain attributable to the area of land falling outside the permitted area has at any time been used in the business carried on, the entire gain attracts the 10% entrepreneurs' relief rate. It is sufficient that part of the asset can be said to have been in use on the cessation of the business.

A possible exception to the above approach might be where the land disposed of was acquired at different dates, i.e. it was not acquired as a single asset. Where part of the land was acquired with the dwelling house (Area A), but the acreage was added to by a later purchase (Area B), HMRC might be able to argue that, as a matter of land law, the sale comprised two separate assets – and that, to the extent that Area B falls outside the permitted area, the gain thereon should be charged at 28%. That said, by

looking at the history of the ownership of the land over, say, two or three centuries, it may be possible for the taxpayer to show that, in buying the Area B, he was simply unwinding the effect of a disposal by an earlier owner of the dwelling house and accordingly his sale should be viewed as a disposal of a single asset!

Joint ownership

A further complication which I have seen in practice arises out of the joint ownership of a dwelling house by a married couple (or by members of a civil partnership) where a trade is carried on by only one of the owners as a sole trader. In **Stephen and Mary** we take the broad facts from **Stephen 1** with the exception that the dwelling house is owned jointly by Stephen and his wife, Mary. Contrary to the normal expectation when a gain is shared between spouses, the result is an increase to the tax liability of more than £6,000.

“ Contrary to the normal expectation when a gain is shared between spouses, the result is an increase to the tax liability. ”

Summary

This article highlights some of the many complications to be considered when advising on the capital gains tax implications arising on the sale of a dwelling house where part of the property has been used for business purposes. The focus of this article is on sole traders trading from home. A similar article could be written exploring the issues associated with situations where the dwelling house (and/or the associated land) is partly occupied for the business of a partnership or of the vendor's personal company. These trading vehicles present similar, but not identical, issues which need careful appraisal. Similarly, entrepreneurs' relief may be relevant in situations where the taxpayer's dwelling house is held in a settlement and the capital gains tax main residence exemption applies under s 225. Careful attention is therefore also required when advising in such situations. ■

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