Interesting interactions

When might commercial property be residential? **KEVIN SLEVIN** considers a troublesome aspect of the higher rate of capital gains tax that has applied since 6 April 2016.


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Under the heading 'Capital gains tax rates and annual tax-free allowances' (tinyurl.com/leut8ts) and referring to the tax year 2016-17, HMRC's website states:

'The following capital gains tax rates apply (the tax rate you use depends on the total amount of your taxable income, so you need to work this out first):

- 10% and 20% tax rates for individuals (not including gains attributable to residential property and carried interest);
- 18% and 28% tax rates for individuals for residential property and carried interest;
- 20% for trustees or for personal representatives of someone who has died (not including residential property);
- 28% for trustees or for personal representatives of someone who has died for disposals of residential property.'

Although HMRC's website does show a link to help to explain how entrepreneurs' relief can also affect the situation, there appears to be no pointer to help taxpayers (apologies, I mean 'to help customers') to determine what the term 'residential property' means. Neither is there a link to any explanation as to the meaning of 'carried interest', but it is not unreasonable to assume that those realising gains on such a source will have tax advisers to help them to find their way through the maze we call capital gains tax.

HMRC's website does helpfully include a page entitled 'Tax when you sell property' (tinyurl.com/twysp), but this makes no reference to residential property. At various points on the website there are references to the disposal of such property by individuals *not* resident in the UK. There are also references to the tax treatment of particular high value properties under the annual tax on enveloped dwellings (ATED) provisions. However, unless I am missing something (again), one would not normally anticipate the aforementioned links to be the 'go-to places' by UK resident individuals seeking guidance on their capital gains tax position if they sell a UK property owned personally by them.

KEY POINTS

- A plethora of capital gains rates apply from 6 April 2016 depending on the nature of the gain.
- A higher rate applies to residential property but how is that defined?
- Residential property appears to depend on *suitability* for use as a dwelling.
- A commercial property that could be easily converted to residential might attract a higher rate of tax.
- Care may be needed regarding the allocation of entrepreneurs' relief.

Defining a dwelling

It may be that I am being a little harsh, so I should point out that a UK resident individual contemplating selling a UK property and therefore in search of guidance as to what HMRC means by residential property might decide to read the guidance for non-resident individuals selling UK property (tinyurl.com/nrrshxf). This may be by mistake rather than genuine curiosity, but there is commentary to be found under the headings 'What counts as residential property' and 'What isn't residential property'. Alas, the clarification given is on the shallow side and so leaves more than a little to be desired.

Readers are referred to two previous *Taxation* articles on this topic, the first by Michael Blake ('Peculiar entities', 2 November 2016, page 12) and the second by Mark Wallace ('Residential rate', 7 December 2016, page 18). I do not propose to repeat their detailed explanations, but suffice it to say that 'residential property gains' are defined in TCGA 1992, s 4BB as those arising on the 'disposal of a residential property interest'– a term that extends to both UK and non-UK residential property interests. This is defined as meaning, among other things, land that has at any time in the taxpayer's relevant period of ownership consisted of or included 'a dwelling'.

Under TCGA 1992, Sch B1 para 4, a building is a dwelling 'at any time when it is used or suitable for use as a dwelling or is in the process of being constructed or adapted for such use'. For this purpose land which at any time is, or intended to be,

PARTNERSHIP PROPERTY

A partnership operated from a large Victorian property constructed for use as a residence. It was thought that the business use of the property had started soon after the second world war – well before the partners had acquired it. Planning consent was in place for such use.

Some modifications had been made over the years, but none had changed the impressive character of the property. Some of the large bedrooms had been partitioned to create two or more offices, but it was clear that the stud walls could be easily removed and the building returned to its former glory. All the open fire places appeared to be in their original state and the old kitchen in the basement was still used as one and had been fully fitted with all that one would expect in a modern kitchen. There was also a restroom.

The partnership acquired the property about 15 years ago and used it throughout for the business of the partnership. At no stage had it been used for residential purposes. Some years ago, the original bathroom on the second floor had been modernised to make it into a modern shower facility available to partners and staff. The partnership had refurbished the building from top to bottom during their ownership but, fundamentally, apart from the foregoing only minor modifications had been made. These included installing better fire escapes and improvements to comply with health and safety regulations.

When asked whether it would take much time and effort to restore it for use as a dwelling the response was it could be done within a week; the longest job would be choosing the curtain material.

occupied or enjoyed with a dwelling as a garden or grounds (including any building or structure on such land) is taken to be part of the dwelling at that time.

In short, the question concerning me is how, in light of the foregoing, does HMRC interpret the phrase 'suitable for use as a dwelling'.

Repurposing a definition

Fortunately, we are not having to explore pastures new. The term 'suitable for use as a dwelling' features in the ATED provisions referred to above (see FA 2013, s 112). Alas, these provisions do not contain a clear definition – indeed HMRC's *ATED – Technical Guidance* document (tinyurl.com/atedguid) simply refers us (at 19.2) to the department's guidance on the interpretation of the phrase in relation to its earlier use for stamp duty land tax purposes. It states:

> 'Furthermore, a dwelling is defined not only as a property that is used as a dwelling but also one that is suitable for use as a dwelling. This is a concept that exists in SDLT and the definition can be found [at] SDLTM20076. Whether a property is suitable for use as dwelling is a question of fact. Broadly the same approach will also be taken in ATED as in SDLT. SDLTM20076 states that:
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> "Use at the effective date of the transaction overrides any past or intended future uses for this purpose. If a building is not in use at the effective date but its last use was as a dwelling, it will be taken to be 'suitable for use as a dwelling' and treated as residential property, unless evidence is produced to the contrary.
>
> "Undeveloped land is essentially non-residential but may be residential property if, at the effective date, a residential building is being built on it.
>
> "Where, at the effective date, an existing building is being adapted or marketed for, or restored to, domestic use, it is treated as residential property."'

Why is this important? Perhaps at this stage we should look at ***Partnership Property***, a typical situation that may be familiar to many readers – a local business occupies as its commercial premises a property that was originally residential.

> ***"The question concerning me is how, in light of the foregoing, does HMRC interpret the phrase 'suitable for use as a dwelling'."***

I suspect that many readers will act for businesses using such premises in towns and cities up and down the country. But what happens if the premises are to be sold? The question in ***Partnership Property*** is whether HMRC could successfully argue that the property has been suitable for use as a dwelling throughout the partners' ownership, even though it has only been used for business purposes. The short answer is that such an unfair result cannot be ruled out.

Fit for purpose?

Arguably the legislation is so unclear that it relies on HMRC taking a sympathetic approach if a fair result is to be secured. It can and does happen.

The department's *Stamp Duty Land Tax Manual* at SDLTM09525 states that a property with a long history of non-residential use, and which does not have permission to be occupied as a residence, is unlikely to be viewed by HMRC as a dwelling, or *suitable for use as a dwelling*. But this guidance to HMRC staff goes on to state: 'HMRC may take a contrary view where, for example, a property's last use was as an office but, before the property is sold, planning permission is granted for use as a dwelling, provided that, at the effective date of the transaction, the property is otherwise suitable for use as a dwelling or is being adapted for such use.'

One difficulty experienced in interpreting the position was that, in essence, HMRC's stamp duty land tax guidance applied to the situation on a given day; namely, the day of the disposal transaction. However, the capital gains tax position is to be determined on a daily basis throughout the taxpayer's period of ownership.

Another point to bear in mind here is that the capital gains tax position will be determined in respect of the vendor whereas the stamp duty land tax position will be a matter for the purchaser.

It is understood that there have been discussions with the Stamp Office over a long period, but clarification as to just what falls to be treated as residential accommodation is still taking place and the 'suitable for use' issue is one of the topics on the agenda.

Some readers may have already found their way to paragraph 28.2 of HMRC's ATED guidance, which states in relation to the conversion of dwellings to non-residential use: 'If any planning permission or development consent is required for the alterations, the building will not be regarded as having become unsuitable for use as a dwelling unless this has been granted and the alterations have been made in accordance with it.'

This may imply, particularly to readers who are by nature optimistic, that HMRC may accept the converse. Could it be therefore that HMRC will disregard the potential for use as a dwelling even where the building is physically suitable unless there is planning consent in existence for use of the property as a dwelling? However, such optimists should be aware of the context in which this particular part of the guidance is being given. The previous paragraph thereof (28.1) states: 'Where a building (or part of a building) has been suitable for use as a dwelling and is altered so as to make it suitable for some other purpose, whether or not the building then ceases to be suitable for use as a dwelling is a question of fact.'

Consistent with this, when asked recently about the lack of certainty generated by the 'suitable for use' phrase regarding the provisions connected with the determination of the appropriate rate of capital gains tax, HMRC was constrained in its response, stating only: 'Whether a dwelling is still suitable for use as such will be a question of fact. Simply putting in some office furniture does not make it unsuitable for use as a dwelling.'

In this context of the ***Partnership Property*** example, HMRC also indicated that 'removal of domestic-type bathrooms and kitchens and certain alterations to the floor plan might be relevant modifications' but, as already indicated, it will be a question of fact in each case. It is establishing the facts may be the problem.

Cases of doubt

In all, it is difficult not to question the wisdom of repurposing a stamp duty land tax provision that is still controversial more than ten years since its introduction. However, the uncertainty is what we must live with for the time being.

In cases where there is doubt as to whether HMRC will try to advance the 'suitable for use as a dwelling' argument with a view to establishing an upper rate gain, it is important to consider entrepreneurs' relief. Remember that if the disposal relates to a situation in which this is claimable, the taxpayer can remove up to the balance of his unused £10m entrepreneurs' relief lifetime allowance from the 28% upper rate – thus saving 18%. If there is uncertainty as to the likely status of a property comprised in a disposal, it is possible to allocate the entrepreneurs' relief to apply to such gains as the taxpayer chooses.

Let's consider one scenario where problems may arise.

Partnership disposal

The partners in ***Partnership Property*** dispose of their business to a company resident in the UK at the same time as they dispose of the business premises to a UK property developer who specialises in restoring former Victorian residences. It is calculated that each partner's aggregate of assessable capital gains (on the gain on both the goodwill disposal and the property disposal) amounts to £13m. Accordingly, at least £3m of each partner's capital gain will be taxed at a rate greater than 10%.

The partners should first identify their entrepreneurs' relief claim with the property disposal. Let's assume that each partner's gain on the property is £4m with the £9m balance relating to their share of the goodwill and that the maximum relief is available. By first claiming entrepreneurs' relief against the £4m property gain, each partner will pay 10%. The first £6m gain on the goodwill disposal will be taxed at the 10% entrepreneurs' relief rate and the £3m balance will be taxed at the 20% rate.

This can be contrasted with the situation in which the 10% entrepreneurs' relief rate is applied first by the taxpayer to the £9m gain on goodwill (otherwise taxable at 20%), leaving the first £1m gain on the property to be taxed at 10% and the balance at 28%. We are also assuming here that the property is ultimately held to be residential because it was thought to be suitable for use as a dwelling by HMRC.

Conclusion

It is the taxpayer who can choose how to allocate his entitlement to entrepreneurs' relief. If there is doubt about the status of a gain on a property disposal it clearly makes sense to claim the relief rate against the gain on the disposal in question.

There may be situations in which entrepreneurs' relief is not available to mitigate the potential liability on residential property. One possible scenario is when the property is owned by a third party who lets it as commercial premises. If HMRC is able to sustain an argument that this was suitable for use as a dwelling, the vendor could face a substantial increase in their liability. Remembering that capital gains tax is calculated by reference to the period of ownership, this is where the property details at the time of purchase may become very relevant. In fact, my attention has just been drawn to the sale details of a residential property that has for many years been used as a doctor's surgery. I see that the estate agent's particulars state that 'the property may have some potential for conversion and change of use from its current class D1 use, subject to the usual consents and planning permission'. Could this affect the tax position of the present vendor and could it return to haunt the purchaser some years down the line when they sell?

Care will be required when advising clients on the sale of business premises and the potential capital gains tax liabilities. Practitioners will need to understand whether the property they are dealing with is commercial or residential. ■

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