MACFARLANES

TAXATION OF CORPORATE OWNED REAL ESTATE

INHERITANCE TAX CHANGES

This note deals with the Consultation Paper published on 18 August 2016, insofar as it relates to the treatment of residential property held through non-UK corporations.

BACKGROUND

On 8 July 2015 the then Chancellor of the Exchequer, George Osborne MP, announced that UK residential property held through non-UK corporations would be within the scope of UK inheritance tax. The details of the changes were not available at the time of the announcement and indeed we have been waiting for the past year for the initial consultation document. This was finally published on 18 August 2016. The new rules apply from 6 April 2017 and, as a result, indirect owners of UK residential property have only a limited time in which to take action.

THE CHANGES

The proposed changes set out in the Consultation Paper are intended to ensure that the value of UK residential property held through non-UK corporations is subject to UK inheritance tax. At present (and until 5 April 2017), non-UK corporations change the situs of property for inheritance tax purposes, from being UK property, which is subject to inheritance tax in the hands of an individual owner or the hands of a trustee owner irrespective of their residence or domicile position, to non-UK property, which is not subject to inheritance tax (as “excluded property”) in the hands of a non-UK domiciliary until they have been resident in the UK for a period exceeding 16 years in any period of 20 years or trustees of trusts settled by non-UK domiciliaries.

There are many reasons why individuals chose to own property through non-UK corporations, aside from inheritance tax. For example, it might be possible to identify a buyer of the property in the future who would be prepared to purchase the shares in the company (thereby saving stamp duty land tax). In addition, the ownership of the property would be registered in the name of the non-UK corporation and so the identity of the beneficial owner of the company would be kept confidential. Prior to 6 April 2013, non-UK resident corporations were not subject to capital gains tax or corporation tax on gains on the disposal of UK residential property.

Since April 2013, there has been discouragement of the use of non-UK corporations to own residential property in the UK. This was initiated through the enactment of the Annual Tax on Enveloped Dwellings (**ATED**) regime, which imposes an annual charge to tax based on the value of residential property held through corporations initially starting with the properties worth in excess of £2m but now applying to all properties with a value of more than £500,000. At the same time, ATED-related capital gains tax was introduced to subject corporations holding residential real estate within the ATED regime to capital gains tax on the value over and above the April 2013 value on a later disposal of the property. Now the inheritance tax advantages of such structures are likely to be removed with effect from 6 April 2017 and the beneficial ownership of UK residential property is likely to be made public through the proposed introduction of a Persons of Significant Control-style register which will seek to identify beneficial ownership of non-UK corporations.

All of these changes taken together mean that, unless rented to a third party, it is unlikely to be attractive for individuals or trustees to hold UK residential property through non-UK corporations in the future. Removing such properties from corporations (a process known as “de-enveloping”) is likely to be a priority, where it can be done without significant tax cost (which is not always the case, particularly where there is a trust involved).

THE NEW INHERITANCE TAX REGIME

The new regime will apply to residential property held in the UK through non-UK corporations which are closely held (meaning controlled by five or fewer participators – broadly, shareholders).

In most cases, the question of what constitutes residential property for these purposes will be straightforward, although the consultation debates the finer detail of how “residential property” should be defined – the choice being between the (broadly consistent) definitions currently applicable for the purposes of ATED and non-resident capital gains tax. Whatever approach is ultimately taken, it is clear that unlike ATED the extended inheritance tax regime will apply irrespective of the value of the property (so there will be no “cut off” for properties worth less than £500,000) and will apply irrespective of whether the property is vacant, occupied by the beneficial owner of the non-resident corporation or indeed let to a third party. We should therefore expect the legislation to be very broad and will apply to all residential property.

The consultation document also addresses the question of the change of use of properties. In the context of non-resident capital gains tax, if a property was bought as a commercial property but then converted to residential use, the gain is time apportioned between the taxable element (the residential element) and the non-taxable element (the commercial element). However, whereas capital gains tax looks at the gain in value of an asset over time, inheritance tax is charged on the snapshot value of an asset on the date of a chargeable event. In the case of individuals this would normally be a death but can be a gift, whether a potentially exempt transfer which becomes a chargeable transfer through a death within seven years of the date of gift or a gift to the trustees, which is immediately chargeable.

The Government's proposal is that where the property has not been used as a dwelling within two years of the date of the chargeable event, it will not be subject to inheritance tax under the new rules. Note that if residential property is simply empty, that will not be enough to be exempt. But a residential property would not be charged if it were converted into commercial premises (e.g. offices) more than two years before the chargeable event.

Likewise, the consultation document addresses the (somewhat common) scenario where the property in question has a mixed use. For example, a commercial property may be owned which contains a small flat. In that case, the proposal is that the value of the flat should be assessed independently of the commercial property on a just and reasonable basis.

THE MANNER OF THE CHARGE

The manner of the charge is somewhat complicated. Whilst the charge is based on the value of residential property, the existence of the company cannot simply be ignored. The legislation deals with this issue by taxing the shares in the company to the extent that their value is attributable to the value of the UK residential property (but not the value of any other property owned by the company). This also means that the shares may be worth less than the actual property (for example, because the shares are less easily marketable than the property itself).

If the company holds a mixed portfolio of assets, e.g. a residential property and a securities portfolio, the securities portfolio is ignored for valuation purposes. There may well be difficulties in this approach, for instance, where there are multiple shareholders and / or different share classes carrying difference rights. Should each shareholder's interest be valued according to general principles or with a specific set of rules (or restrictions)? The Government is consulting on this further.

LIABILITIES

The consultation proposes that only relevant debts will be deductible in computing the value of the UK residential property for the purposes of the charge. It states that relevant debts are those which relate exclusively to the property and gives the example of an outstanding mortgage used to purchase a property. It is not yet clear how restrictive the category of relevant debts will be – for instance, will equity release (where funds are borrowed secured on a property and spent) result in an increase in the deductible value of debt under the new regime? Furthermore, it is not clear whether this signals a tightening of the existing restrictions on the deductibility of debt for properties directly owned by individuals, or whether the proposals in the consultation will be restricted to property owned by non-UK corporations.

In certain circumstances connected party debt has been used in order to depress the value of property, e.g. so-called "double trust" structures. The consultation document makes it clear that the value of loans made between connected parties will be disregarded when determining the value of property which will be chargeable to inheritance tax. Depending on the definition of connected party used, this could create significant issues for some families. Again, it is unclear whether this measure will be restricted to property owned by non-UK corporations or whether it will be of wider application.

TAX AVOIDANCE

The legislation will contain its own targeted anti-avoidance rule. This will enable HMRC to disapply any arrangement which has as its sole or main purpose avoiding or mitigating a charge to inheritance tax on UK residential property. As with the points raised about liabilities above, the scope of this new targeted anti-avoidance rule is not entirely clear. The draft legislation implies that it is effectively limited to arrangements intended to circumvent the extended regime but the consultation paper itself implies that it may apply more widely.

LIABILITY AND ACCOUNTABILITY

There is a clear problem with collecting tax where the owner of the property, the value of which is to be assessable to tax, is a non-UK corporation. The Government intends to address this by extending responsibility for reporting to HMRC when chargeable events have taken place and for paying any tax which arises. Any person that has legal ownership of the property, including the company itself and, crucially, any directors of that company, will be personally liable for any outstanding inheritance tax. The inheritance tax legislation in any event contains little-used provisions which enable the inheritance tax liability to follow the property in certain circumstances. We expect that one of the questions to be included in the standard pre-contract enquiries will be to check whether any inheritance tax is owing on the property, under the new regime.

DE-ENVELOPING

There will be no de-enveloping relief. This is disappointing. See below for our further commentary on the subject.

COMMENTARY

There is a long way to go before the legislation which would enact the changes set out above is finalised and indeed, the details of the changes remain unclear. Nonetheless, the direction of travel is clear. Residential property held through non-UK corporations as at 6 April 2017 will be subject to inheritance tax.

For many, this will be the imposition of a form of retrospective taxation. Unlike in respect of the ATED-related capital gains tax regime, where value accrued to the date of introduction of the regime in April 2013 was ignored for the purposes of calculating the charge, the charge in this case is on all the value held by the corporation, irrespective of when the corporation acquired the residential property. An individual dying on 6 April 2017 without having addressed the structure in question would find that the entire (in some circumstances net) value of the residential property is exposed to inheritance tax.

A form of de-enveloping relief to allow structures to be terminated without any liability to tax was rumoured to be under consideration but has not been enacted. The difficulty with de-enveloping is often stamp duty land tax, particularly where debt is secured on a property. Extracting the property from a corporation can trigger a liability to stamp duty land tax on the value of the debt assumed by the transferee (normally the shareholder).

We suspect that the reason for not enacting any form of de-enveloping relief is that ATED (which is now a tax which confers no benefit whatsoever, previously having been a price worth paying for inheritance tax protection in many cases) has proved to be more lucrative for the Government than first anticipated: it raised approximately £100m in 2013/2014 and £116m in 2014/2015. The choice for clients between April 2013 and 5 April 2017 has been ATED payments or inheritance tax exposure. The Government now wants both.

Given the clear direction of travel, we doubt if there will be many substantive changes to the proposed regime through the consultation process. The truncated consultation timetable also makes any substantial policy changes unlikely. For this reason, clients must now turn their minds to considering their structures and, if approprioate, de-enveloping as quickly as possible. There may be a price to be paid for de-enveloping in the form of stamp duty land tax, but even if at its highest rate (15 per cent), that may be less than the inheritance tax exposure.

One point which is not addressed at all in the consultation document is the treatment of property held through trusts where the reservation of benefit rules apply. In a settlor interested trust, the settlor can be treated as retaining a benefit in the underlying property and, as a result, the value of property will be subject to tax both under the inheritance tax ten year charge regime (in the case of a discretionary trust) and under the reservation of benefit regime. One would think that if a non-UK company owns property and the company is held by an individual, the company could be left to a surviving spouse and the spouse exemption should apply. But what if a property is held by trustees? The spouse exemption is not generally available in such circumstances. Clients holding property through such structures will need to consider urgently how to deal with the issue.

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