Inheritance tax: UK residential property held through offshore structures

Currently, where UK residential property is held by non-UK domiciled individuals or certain related trusts via an overseas company, it falls outside the scope of inheritance tax (IHT). The Government has now provided further details of how it intends to prevent this in future.

Background

Individuals who are domiciled in the UK are liable to IHT on all their property whether it is situated in the UK or overseas (subject to any available reliefs and exemptions).

By contrast, non-UK domiciled individuals ('non-doms') are only liable to IHT on property situated in the UK.

Similarly, a trust is not liable to IHT on overseas property if the settlor was a non-dom at the time the trust was made and the trust does not directly own UK assets.

If an individual owned a UK residential property directly it would be within the scope of IHT, subject to a possible deduction for the nil rate band, potentially resulting in a charge at 40% on death. The fact that the owner may be a non-dom is irrelevant if the property is in the UK. The basic limit for the nil rate band is currently £325,000; the limit may be higher when a spouse's unutilised nil rate band is transferred or where an interest in a home is passed to descendants.

If a UK or non-UK trust owned the property, then depending on the type of trust, the value of the property would be charged to IHT at a maximum of 6% every 10 years (the ten-year 'anniversary charge'), or it would be within the estate of a particular beneficiary. If the settlor of the trust had an interest in a trust within the ten-year anniversary regime, the property would also be treated as within his estate, leading to potential double charges..

These rules have given rise to a common practice of non-doms 'enveloping' UK residential property, i.e. holding it via an overseas company, or settling an overseas trust that owns the property via such a company. In this structure the property held by the individual or trust consists of the shares in the overseas company which, because they are not situated in the UK, are not within the scope of IHT.

The proposed changes

In the July 2015 Budget, the Government announced that from 6 April 2017 shares in an overseas company would (effectively) be treated as situated in the UK if the value of the company was attributable to an interest in UK residential property.

Other changes to the treatment of non-doms were announced at the same time, but in general these only affect individuals who have a long-term connection with the UK, and who will in certain circumstances be deemed to be UK-domiciled. By contrast, the changes to the treatment of residential property will potentially affect all non-doms, whether they are resident in the UK or not. For details of the other changes see our factsheets '*Changes to the taxation of non UK domiciliaries – first thoughts*' and '*Non-domiciled individuals – individuals born in the UK with a UK domicile of origin*'.

The detailed rules

The Government has now issued a consultation document on the implementation of all these changes. This is accompanied by draft legislation for some of the areas concerned, while that for other areas will be issued later in the year.

This material indicates that shares or other types of property will be treated for IHT purposes as situated in the UK at any time if their value is attributable to a UK property that is a dwelling at that time, or has been a dwelling at any time in the preceding two years. Any arrangements that have a main purpose of avoiding this provision will be ignored.

The new rules apply irrespective of who occupies the property. There is no relief for property let commercially, as there is for the purposes of the annual tax on enveloped dwellings (ATED). The rules do not apply to commercial property, but they extend to dwellings that form part of a larger building; for example, apartments in office blocks, or flats over shops.

The consultation document indicates that the change applies to shares in closely held companies and similar entities (including partnerships), but not to other companies (although at present the draft legislation seems to include all companies). However, in most cases there will be a single property held by an overseas company that is owned either by offshore trustees or by a non-domiciled individual who may or may not be UK resident, and the situation will clearly be within the new provisions.

These changes have no effect on the IHT position of UK-domiciled individuals or of trusts settled by such individuals, because they are already liable to IHT irrespective of where the assets are situated.

Valuation

The extent to which the value of shares is derived from UK property will be a matter to be determined according to the facts of the particular case. The consultation document makes it clear that this is not simply a matter of 'looking through' the company and treating the residential property as held by the individual or trust.

Example 1

An individual dies owning all the shares in an overseas company with an open market value of £950,000. If the company owns a residential property with a value of £1 million, and has no other assets, then all the £950,000 market value of the shares will derive from residential property in the UK, and that amount will be liable to IHT. The individual will not be treated as owning the property with a value of £1 million.

Example 2

An individual dies owning 30% of the shares of an overseas company. The company owns a residential property in the UK with a value of £1 million, and a residential property in France, with a value of £1.5 million.

A 30% interest in the company has an open market value of £500,000. In the absence of special circumstances this will be treated as derived from the UK property as follows:

$$£500,000 \times \frac{£1,000,000}{£1,000,000 + £1,500,000} = £200,000$$

The document indicates that the value of a property will take account of debts that relate exclusively to the property, such as amounts outstanding on a mortgage taken out for its purchase. However, loans made between connected parties will be disregarded, which will presumably include loans from shareholders to the company. These provisions are not yet reflected in the draft legislation.

Reporting obligations

The consultation document indicates that further draft legislation will be published later in the year to extend to additional parties the obligation to report the occurrence of a chargeable event. This will also give HMRC the power to prevent the sale of an indirectly held UK property until any outstanding IHT is paid. In addition, a new liability for payment of the tax will be imposed on any person who has legal ownership of such a property, including the directors of a company. Presumably, this will apply only if the individual or trustees with the primary liability do not meet it.

Chargeable events

The change applies to chargeable events arising on or after 6 April 2017. Where a UK property is held by an overseas company these events might include:

- the death of an individual owning shares in the company;
- transfers of such shares (for example to a trust);
- the death of an individual who has made a gift of such shares within the last seven years;
- the death of an individual who has given away such shares subject to a 'reservation of benefit' such as use or potential use of the property;
- a ten-year anniversary of the establishment of a trust.

For a trust's first ten-year anniversary after the rule changes bring it within the scope of IHT, existing provisions would reduce the charge proportionately to take account of the part of the ten-year period that fell before the change. So, for example, a ten-year charge arising on 5 April 2018 (one year after the change) would be reduced to one-tenth of the full amount. The draft legislation currently does nothing to disturb this position, but there can be no guarantee that this will be maintained when the legislation reaches its final form.

The timing of the consultation document and draft legislation When the changes were first announced in the July 2015 Budget it seemed that there would be ample time to consider their implications before their implementation in April 2017. However, more than half that time has passed before the issue of the consultation document, and draft legislation is still awaited on some aspects of these rules, as well as on other changes to the non-dom regime which may affect the incidence of taxation on overseas structures. The consultation runs until 20 October 2016, after which it will inevitably take some time for the Government to consider responses and decide on any changes. The result is that, at best, by the time the final shape of the legislation is known there will only be three or four months before it takes effect.

Implications

The result of the changes, clearly, is that the IHT benefit of using an indirect ownership structure is lost. Such a structure may well have a tax cost in the form of an ATED charge, which (broadly) applies where UK residential property is held by a company. There are certain reliefs from ATED, for example where the property is commercially let, but where none of these apply ATED can be as much as £218,200 pa for the most expensive properties.

It may therefore be appropriate to 'unwind' the structure so that the property is held directly by the individual or trustees. However, depending on the circumstances, this may have the effect of crystallising tax charges, in particular on UK resident individuals who have had the benefit of rent-free occupation of the trust property, or UK-resident shareholders of the property owning company. It had been hoped that the Government would give some relief from such charges to encourage de-enveloping ahead of April 2017 but the consultation document makes it clear that no such amnesty will be given. Careful consideration will therefore be required, and professional advice should always be taken.

In some circumstances it may be appropriate to liquidate the company and distribute the property to the trustees so that it is held by them directly. This may give rise to an immediate tax charge, but there may then be the possibility of sheltering future growth in the value of the property if it is used as the main residence of a beneficiary. It will often be necessary to appoint liquidators in the jurisdiction of the company, and the liquidation process may be time consuming. If the objective is to unwind existing structures before 6 April 2017 it may be necessary to begin the process sooner rather than later.

If the terms of the trust are such that the settlor may benefit from it (a 'settlor-interested trust') the changes may mean that an IHT charge can arise on the property both at the ten year anniversaries of the trust and on the death of the settlor. In some cases it may be appropriate to amend the terms of the trust to exclude the settlor from any benefit, in order to prevent this double charge.

In terms of planning for the IHT liability a popular option may be to insure the tax liability through the use of a life assurance policy. This could be a policy for a specified term or, if the property is likely to be held for a long period of time, a whole of life solution could be used.

The most appropriate course of action may be influenced by the circumstances of the particular individuals concerned. For example, if shareholders of the company (or the settlor or beneficiaries of a trust) are about to become non-resident it may be better to wait until that is the case before undertaking transactions that give rise to capital gains.

Moore Stephens will be pleased to advise on the advantages and disadvantages of the possible courses of action. There is no 'one size fits all' solution. The position of each structure and the individuals connected to it requires careful consideration. Similarly, should you require insurance quotations for the tax liability we will be happy to provide them.

For more information please contact your usual Moore Stephens tax advisor.

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