BRIEFING NOTE

October 2016

ROOKS RIDER SOLICITORS

IHT: UK Residential Property held through Non-Resident Trust Structures

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

Outline

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

By contrast, non-UK domiciled individuals are only liable to IHT on property situated in the UK. In the same way, a trust is not liable to IHT on overseas property if the settlor was a non-UK domiciliary 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-UK domiciliary is irrelevant if the property is in the UK. 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 6% every ten years (known as "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 the trust within the ten year anniversary regime, the property would also be treated as being within his estate, leading to potential double charges.

These rules have given rise to a common practice of non-UK domiciliaries enveloping UK residential property, i.e. holding it via an offshore company or settling an offshore 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 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 6th April 2017, shares in an overseas company would effectively be treated as situated in the UK if the value of a company was attributable to an interest in UK residential property.

Other changes to the treatment of non-UK domiciliaries were announced at the same time but, in general, these only affected 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-UK domiciliaries whether they are resident in the UK or not. For details of the other changes see our Briefing Note "*Reform of the Taxation of Non-UK Domiciliaries*".

The Specific 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 documentation 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 on the facts. The consultation document makes it clear that this is not simply a matter of looking through the company and treating the residential properties as held by the individual or trust.

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 would no doubt include loans from shareholders to the company; it could also include, for example, loans from other trusts or family members. 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 the obligation to report the occurrence of a chargeable event to parties other than Trustees and Beneficial Owners, such as Directors of an overseas company. 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 only apply 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 6th April 2017. Where a UK property is held by an overseas company. These events might include:-

1. The death of an individual owning shares in the company;
2. Transfers of such shares (for example, to a trust);
3. The death of an individual who has made a gift of such shares within the last 7 years;
4. 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;
5. 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 5th April 2018 (one year after the change) would be reduced to 1/10th of the full amount. The current draft legislation currently does nothing to disturb this position.

If the terms of the trust are such that the settlor may benefit from it 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.

The Impact

The result of the changes 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, on current rates, ATED can be as much as £218,200 per annum 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 accommodation 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 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 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 6th April 2017, it may be necessary to begin the process sooner rather than later.

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. 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.

The consultation ran until 20th October 2016; further information may be published with the Autumn Statement on 23rd November and the Finance Bill on 5th December 2016.

ROOKS RIDER SOLICITORS

For further information on any of the issues raised in this Briefing Note, please contact a member of the Rooks Rider Solicitors Wealth Planning Team.

Karen Methold
Partner
Head of Wealth Planning
+44 (0)20 7689 7112
kmethold@rooksrider.co.uk

Christopher Cooke
Senior Partner
Corporate & Wealth Planning
+44 (0)20 7689 7110
ccooke@rooksrider.co.uk

Robert Drysdale
Associate
Wealth Planning
+44 (0)20 7689 7168
rdrysdale@rooksrider.co.uk

James John
Partner
Head of Real Estate
+44 (0)207 689 7152
jjohn@rooksrider.co.uk

Rooks Rider Solicitors LLP
Challoner House
19 Clerkenwell Close ■ London ■ EC1R 0RR

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