



Proposed changes to Inheritance
Tax for UK residential property

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Proposed changes to Inheritance Tax for UK residential property

On Friday 19 August 2016 the UK Government released their long awaited consultation document on the proposed changes to Inheritance Tax ("IHT") on UK residential property. On 5 December 2016 they issued their response to the consultation.

These changes will have a large impact on any non-UK domiciled individuals (non-doms), or any offshore trusts settled by a non-dom, that hold UK residential property through an offshore company or similar arrangements such as a partnership.

Also any UK residential property structuring arrangements which currently involve debt will be affected.

The below is intended as a brief overview of the changes. If this issue affects you or your clients you should obtain further advice by contacting one of our tax advisors listed below, or your usual SMP contact.

What are the current rules?

A non-dom who holds UK assets directly, such as UK residential property, is already subject to IHT on those assets, whereas a non-dom who holds foreign assets is not subject to UK IHT on those assets.

This applies both for non-dom individuals, or a trust that was settled by a non-dom.

It is standard practice for non-doms to hold UK residential property through an offshore or non-UK company. What the non-dom holds in this situation is the shares in the foreign company not the underlying UK residential property. The assets therefore do not currently fall within the charge to IHT.

This is commonly known as 'enveloped property' and this type of structure has been subject to several tax changes over the past few years, such as the introduction of the Annual Tax on Enveloped Dwellings ("ATED") and ATED related Capital Gains Tax ("CGT"). These issues are covered in a separate briefing sheet so please contact us for further details on these matters.

What's changing?

The Government intends to bring UK residential properties that are held by an offshore company within the scope of UK IHT.

The changes are proposed to come into effect from April 2017.

What does this mean?

A non-dom individual will now be subject to UK IHT on UK residential properties held via an offshore company. This would essentially be chargeable on the value of the property at a rate of 40% on death or 20% on a chargeable lifetime transfer (e.g. a transfer of shares of a residential property company into a trust).

An offshore trust settled by a non-dom will also be subject to UK IHT on UK residential properties held via an offshore company. This would be at up to 6% every 10 years or on an exit from the trust. Also there would be a 40% charge on the death of the settlor if the trust is a settlor interested trust.¹

¹ A trust will be a settlor interested trust unless the settlor is specifically excluded from the trust.



How will they change the rules to achieve this aim?

The shares in an offshore company will no longer be excluded property to the extent that the value of those shares is derived from residential property in the UK.

This applies only to close companies and similar entities.

The consultation provided the following example of how the shares would be valued:

A non-dom is the sole shareholder of an overseas company whose sole assets consist of a UK residential property.

- The company has no liabilities.
- At the individual's death, the overseas shares have an open market value of £950,000.
- At the same time, the UK property has an open market value of £1 million.
- The value of the estate is calculated as £950,000 (the value of the shares, not the property).

IHT would be charged on the value of £950,000.

The draft legislation also deals with cases where a UK residential property owned through a non-UK company has been sold. The proceeds of the sale will be treated in the same way as a UK residential property for the two years following the disposal, i.e. still caught by UK IHT.

Who's liable?

In the Consultation document the Government proposed to give HMRC the following extended powers to deal with the reporting of chargeable events and payment of any tax liability:

1. A property cannot be sold until any outstanding IHT charge is paid.
2. The liability will be extended to anyone with legal ownership of the property, including the directors.

However, the response document removes the proposal to extend the liability to company directors, accepting that this may be impractical in some cases.

The Government will instead consider what alternative approaches would ensure the extended charge can be enforced.

Can the IHT charge be reduced?

Yes, if there is a mortgage on the property or a debt which relates to the property.

However, the Government have proposed that where a loan has been taken out to acquire or maintain a UK residential property, that loan will be subject to UK IHT in the hands of the lender. This will apply to all loans, not just those made between connected parties.

Are there any transitional arrangements?

No. The government considered whether they would provide relief for the costs of de-enveloping (such as a Stamp Duty Land Tax ("SDLT") charge where there is a mortgage on the property) however they have now proposed that there will be no relief available.

So what can be done to mitigate the IHT?

The situation will depend on your or your client's individual situation, but a combination of the following may be considered:

- Establish a settlor excluded trust
- Third party debt financing
- Multiple settlors or owners in order to split value of individual ownership and to take advantage of multiple nil rate bands (of £325,000 each, or more in certain cases)
- Insurance to cover unexpected early deaths

Summary

The proposed changes to UK IHT for UK residential properties is the latest change in property taxation. This now renders the difference between holding a property via a company rather than as an individual, or via a trust and company structure, rather than directly by a trust, irrelevant for UK IHT purposes. Despite this change there may still be advantages to holding property, particularly buy-to-let property, through a corporate or trust structure. The position will depend on your or your client's individual circumstances.

If you would like to discuss any of these issues further please contact one of our tax advisors listed below, or your usual SMP contact.

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