Inheritance tax on UK residential property

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Legal Update

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At present, it is relatively easy for non-UK domiciliaries to shield UK assets, such as UK residential property, from IHT. If the asset is held through a foreign company, then for IHT purposes the relevant asset is the individual's shareholding in the company, rather than the underlying UK asset. Because non-UK domiciliaries who are not deemed domiciled are only within the scope of IHT to the extent that they hold UK assets, this technique can currently be used to eliminate IHT exposure on UK residential property.

However, after a couple of false starts[1], the Government will be introducing new rules from 6 April 2017 that will deny non-UK domiciliaries this advantage, where UK residential property is concerned. The new rules will also affect the position of trusts established by non-UK domiciliaries, which own UK residential properties via foreign companies.

The draft legislation and accompanying explanatory notes and consultation document were released very quietly (and to an advisory community that would otherwise be enjoying their summer holidays) on a sleepy Thursday in August. Perhaps this explains why the draft legislation and the explanatory notes do not actually match up: the notes refer repeatedly to items that are simply not included in the legislation. We can only assume that the legislation will be amended in due course…

The draft legislation does, however, give a general idea of how the new rules will work: the definition of "excluded property" (in very broad terms, property that is outside the scope of IHT) will simply exclude assets whose value is attributable to a chargeable interest in a UK residential property. Therefore, if any assets (eg shares in a company) derive their value from UK residential property at the date of a chargeable event (eg the death of a shareholder or a 10 year charge within a trust), IHT will apply.

These changes mean that there will now be very few circumstances in which it will make sense for owner occupiers to hold UK residential property in corporate (or similar) structures. The IHT protection enjoyed by non-UK domiciliaries, and trusts established by them, will no longer apply and the structures themselves will be subject both to capital gains tax (**CGT**) and also to the ATED – ranging between £3,500 each year for properties valued at £500,000 to £218,200 for properties over £20million. The proposed introduction of beneficial ownership registers means that even the privacy benefits of foreign companies as owners of UK residential property are likely, in due course, to fall away.

[1] Most notably, the introduction of the Annual Charge on Enveloped Dwellings (or ATED) in 2013 and the increased stamp duty land tax (or SDLT) for companies purchasing residential property.

"The merger is absolutely fantastic; they have combined two teams of people who are extremely talented. That's extremely good news for anyone who works in the private client area."

Chambers UK, 2016, Private Client

Debts

As is only right, IHT will only apply to the net value of such assets. In theory, this means that debts and other liabilities will reduce the value of the assets and consequently the IHT charge. However, as has always been the case (and increasingly so since the introduction of the "deductibility of debts" rules in 2013), this introduces the difficult topic of which debts will be deductible.

We do not intend here to re-examine this previously well-rehearsed topic. Instead, we focus on one, seemingly innocuous sentence inserted into the consultation document and referred to nowhere else. This must be the most controversial part of the new rules: "The Government intends that any loans made between connected parties will be disregarded when determining the value of the property which will be chargeable to IHT". Is the Government attempting to introduce fundamental changes to the tax treatment of debts by stealth? Even worse, is this a threat of double taxation when it comes to residential properties, debts and IHT?

Let's consider an example: Sue is a non-UK domiciliary. If Sue buys a £10m UK residential property it will be subject to IHT of £4m on her death (subject to the normal exemptions for transfers to spouses etc). After April 2017, this will be the case even if she has bought the property through a BVI company. As part of her tax planning, Sue therefore decides to take a loan of £10m from her UK domiciled brother Fred to fund the purchase of the property. As long as this £10m loan is repaid on Sue's death (in accordance with the rules introduced in 2013), her estate will only pay IHT on any growth in the value of the property over the initial £10m. So far, so good. But, Sue is connected to Fred and the consultation document tells us that the Government intends for loans between connected parties to be disregarded. This would mean that, in fact, Sue's estate would pay IHT on the entire value of the property (including the initial £10m that she has borrowed from her brother). To make matters even worse, Fred (who is domiciled in the UK) has a £10m asset in his estate – the benefit of the loan made to Sue – and this will also be subject to £4m IHT on his death. In one fell swoop the Government has doubled its tax take from Fred and Sue.

At present, the only hint of this potential change is in the consultation document. It is not backed up by current legislation and so it is difficult to see how it would be introduced. A simple change in HMRC policy to disregard debts between connected parties, for example, would not be enough. At this stage, therefore, even though the Government has stated an intention, it currently lacks any bite.

In the above example, Fred is UK domiciled and so the loan that he makes to Sue will remain within the scope of IHT. What if Fred is also non-UK domiciled and therefore only within the scope of IHT in relation to his UK assets? There is a risk that the loan he has made to Sue so that she can acquire a UK residential property would count as a UK asset and so Fred might choose to transfer the loan itself to a non-UK company to ensure that he has no exposure to UK IHT. Somewhat perversely, the legislation makes it clear that the new rules will not look through a non-UK company to a loan secured on the property but this provides no protection for unsecured loans. Fred will therefore want to consider the terms of any loan to Sue very carefully.

Relief (or lack thereof)

When the Government first announced the proposal to change the inheritance treatment of residential property structures back in July 2015, they hinted that relief might be made available for those who now unwind any such structures. Most notably, unwinding holding structures could give rise to CGT (which will depend on the exact nature of the structure and any gains in value since April 2013 or possibly even earlier) or SDLT (eg where third party borrowing is in place). Many were hoping that the Government would introduce a relief of some kind from these potential liabilities. For example, it would have been open to the Government to introduce provisions that would cause third party debts to be disregarded for SDLT purposes, in limited circumstances; or to allow gains realised in the course of restructuring to be held over for CGT purposes until an eventual sale of the property.

However, the Government has now indicated in the consultation document that no such reliefs will be available. Many of those who have adopted a “wait and see” position up to now regarding properties held via non-UK companies will want to push ahead with restructuring and should start discussions with their advisers and service providers as soon as possible.

Anti-avoidance

The draft legislation also includes a targeted anti-avoidance rule. Given the plethora of existing IHT anti-avoidance legislation, this seems unnecessary. But at least it seems extremely narrow in scope: it refers only to arrangements put in place to convert residential property to excluded property.

There is also the question of timing. The wording of the anti-avoidance rule refers to arrangements that are put in place specifically to avoid the effect of the new rules. Given that the new rules will only come into force from April 2017, this seems to mean that arrangements put in place before that date should not be caught. Certainly this should be the case with respect to IHT-mitigation arrangements that were put in place before the Government announced its plan to amend the IHT legislation, to prevent foreign companies from being used as situs changers. That announcement was made on 8 July 2015.

Other points for consultation

There are a few other issues on which the Government is consulting:

- The meaning of "residential property" for the purpose of the IHT rules: the Government has suggested that this is aligned with the meaning used for the non-resident CGT rules. Given its intention to include all types of residential property in the new IHT rule, this seems sensible.

- Changes of use: the new IHT rule will apply to any property that has been used for residential purposes at any time within the two years preceding the date of the chargeable event. This seems unnecessary, given the introduction of the targeted anti-avoidance rule and the inevitable difficulty in changing the use of a property. For those who genuinely do wish to change the use of their property, this rule also seems unfair as they will have no control over chargeable events on death. It will be interesting to see how long it takes for disputes to emerge over what steps are necessary to demonstrate a change of use.

- Valuation: IHT will be charged on the value of the individual or trust's interest in the company and not the residential property itself. This reflects existing IHT valuation principles and therefore seems fair. Whilst it might be possible to depress the value of companies by splitting property ownership between numerous entities or to load companies with liabilities, the targeted anti-avoidance rule might render such planning ineffective.

Conclusions

In general, the proposed new rules achieve the anticipated changes to the IHT treatment of non-UK companies (and similar entities) that hold UK residential properties. There is still some detail to be worked out (including, it would seem, the correct version of the draft legislation) but the Government does not seem to be too far off its aim of introducing the new rules in April 2017. The case for clients to take action in relation to property-owning structures has become clearer.

However, behind the backdrop of relatively sensible draft legislation lurks something more sinister. The Government has hinted that they intend once again to change the IHT treatment of debts. We will be watching this closely through the legislative process.

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