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2017 changes to the taxation of non-domiciliaries
Inheritance tax on UK residential property

Background
The Government announced in July 2015 that an inheritance tax charge would be imposed on UK residential property held through offshore structures. Since then many individuals have deferred decisions about what to do with existing structures.

We now have reasonable certainty that the proposed changes will be implemented with effect from 6 April 2017 as well as the detail of the legislation.

Who will be affected?
The new rules affect all non-UK domiciliaries and the trustees of trusts they have established who hold an interest in an offshore structure which derives its value from UK residential property; from loans used to acquire, maintain or improve UK residential property; or from collateral for such loans or who have themselves made or provided collateral for such loans.

Which assets are relevant?
The new legislation imposes an inheritance tax charge on three categories of property:

— Interests (e.g. loans or shares) in closely held companies which directly or indirectly derive their value from UK residential property. The interest in the top company will still be caught even if there is a chain of companies underneath before you get to the residential property. However, if any of the companies is widely held (for example a real estate fund), this will not be caught.

— An interest in a partnership, the value of which is directly or indirectly attributable to UK residential property. Unlike companies, it does not make any difference how many partners there are and whether or not they are connected. A real estate fund which is structured as a partnership will therefore fall within the new rules.

— The benefit of loans made to enable an individual, trustees or a partnership to acquire, maintain or improve a UK residential property or to invest in a close company or a partnership which uses the money to acquire, maintain or improve UK residential property.

  To avoid back-to-back lending arrangements, assets used as collateral for such a loan will also be subject to inheritance tax under the new rules. An interest in a close company or a partnership which holds the benefit of the debt or the assets which are used as collateral is also caught.

There is a de minimis exception if the value of the interest in the company of partnership is less than 5 per cent of the total value of the company or partnership. Interests held by connected persons have to be aggregated.

There are complex rules to ensure that there is no combination of circumstances which will avoid the application of the new rules if the result is that, one way or another, a UK residential property has been acquired. For example, if a loan is taken out to buy an asset other than UK residential property but that asset is sold and the proceeds reinvested into UK residential property, the original loan will be within the scope of the new rules.

Where a property has mixed use, it is only the value of the residential part which will be subject to the new rules.

One surprising omission from the list of assets which are caught is units in a unit trust although it is debatable whether units in a non-UK unit trust, which holds UK residential property are UK assets and therefore within the scope of UK inheritance tax in any event.

The most surprising aspect is the breadth of the rules relating to loans and collateral. In some circumstances this could lead to double taxation.

Take, for example, a (not uncommon) situation where a settlor interested offshore trust has made a loan to the settlor to enable him to acquire UK residential property. It is likely that the debt will not be deductible from the value of the property for inheritance tax purposes as there are anti-avoidance provisions which deny a deduction for a loan which is made out of assets previously given away by the taxpayer and so, on the taxpayer's death, the full value of the property will be taxable.

However, the benefit of the debt held by the trust will also be subject to inheritance tax on the settlor's death as it will be treated as forming part of his estate under the reservation of benefit rules since he is a beneficiary of the trust. The trustees will also be subject to ten year inheritance tax charges on the value of the debt.

Although the value of any collateral which is caught by the new rules cannot exceed the amount of the loan, the provisions relating to collateral could result in assets worth much more than the value of the house, and certainly worth much more than the amount of the loan which can be deducted from the settlor's estate, being within the scope of inheritance tax. Even in the best case, it effectively denies a deduction for the debt.

For example, if a taxpayer has borrowed £5m from a bank to acquire a property in the UK worth £8m and has pledged his offshore portfolio of £10m as security for the debt, £5m of the portfolio will be within the scope of UK inheritance tax as well as the net £3m value of the house. Tax is therefore still payable on the full £8m value of the house even though there is a £5m of bank debt.

This has led to concerns where the primary security for a loan is the house but the bank has access to other security (such as an investment portfolio) as a result of a pledge contained in the bank's standard terms and conditions or general rights of set off. It is not yet clear how HMRC will treat these sorts of situations but we would hope that HMRC will accept that such generic security is not caught by the new rules. Further guidance is expected later this year.

The changes affect existing arrangements and not just new situations as the new rules will apply to any taxable event which occurs after 5 April 2017. There is no grandfathering for existing structures / loans.

Another surprise is that where property which would otherwise be caught has been disposed of, or a loan which would be caught has been repaid, the proceeds of sale / repayment remain within the scope of inheritance tax for two years.

This means, for example, that if trustees own a company which holds a UK property and that company is sold less than two years before a ten year charge, there will still be a liability to inheritance tax at the date of the ten year charge, even though no UK residential property is owned at that time.

A sale of the UK residential property itself is not caught by the two year rule and so there will be no tax charge even if an inheritance tax event occurs within the following two years.

Which taxable events do the new rules apply to?
All events on which inheritance tax could be chargeable are affected by the new rules. This includes:

- The death of the individual who holds the property or who is a settlor and beneficiary of a trust which holds the property or who has a pre-2006 right to the income from a trust which holds the property.
- Lifetime gifts of any property which is subject to the new rules.
- Ten year charges and exit charges for trusts which hold such property.

The tax charge applies to any inheritance tax events which occur after 5 April 2017. However, if an individual has made a gift of property which is within the new rules before 6 April 2017 and dies after 5 April 2017 but within seven years of having made the gift, this will not give rise to a tax charge, as the question as to whether the gift was of excluded property is tested at the time the gift is made not at the date of death.

Valuation
Where an offshore company has borrowings, the debts will be deducted proportionately from each of the assets owned by the company. This is good news if the company has borrowed to acquire property other than UK residential property, as part of the debt will be deductible from the UK residential property in determining the value on which inheritance tax will be charged. However, it is bad news if the company has borrowed to acquire UK residential property but also owns other assets, as only part of the debt will be deductible from the UK residential property.

Am I protected by a double tax treaty?
The UK only has a small number of inheritance tax double tax treaties (11 in total). In some circumstances, exclusive taxing rights in relation to the sort of property caught by the new rules (for example, shares in a company) would be allocated to the other country.

The draft legislation includes provisions which override these treaties in relation to UK residential property interests (and associated loans/collateral) which are caught by these new rules unless the other country charges inheritance tax or a similar tax and there is actually some tax to pay (however small) in that country.

So, for example, if an individual is domiciled in India (where there is no inheritance tax), the treaty will not assist.

On the other hand, if the individual is domiciled in Geneva but paying tax under the forfait system, there is a 6 per cent charge to inheritance tax on assets passing to a spouse or descendants. It is therefore likely that, as a result of the treaty, there would be no UK inheritance tax to pay.

Anti-avoidance
There is a wide targeted anti-avoidance rule which effectively ignores any arrangements intended to sidestep the new rules. This could potentially apply to some seemingly quite straightforward situations.

For example, if a non-domiciled individual sets up a company to buy a UK investment property (which still may make sense going forward – see below) and arranges for the company to borrow in order to help finance the purchase, even though the individual had enough money to fund the company himself, it could be said that the main purpose of the loan is to minimise the effect of the new rules and should therefore be ignored.

Clearly, we hope that HMRC will take a more pragmatic view in applying the targeted anti-avoidance rule but relying on HMRC's goodwill is somewhat unsatisfactory for taxpayers.

Who will be liable for the tax?
It is only the individual or the trustees holding the asset in question who will be liable for the tax.

The legislation however extends HMRC's charge for any unpaid inheritance tax to the underlying UK residential property. This could give rise to some odd results.

Assume, for example, that a non-UK parent guarantees a loan from a bank to their son which is made in order to enable the son to buy a property in the UK. The parent gives security to the bank over a non-UK investment portfolio. On the death of the parent, HMRC will have a charge over the property owned by the son as security for the payment of inheritance tax by the parent's estate. This would be the case even though the parent has no interest in the property, is not owed any money by the son and the son may not inherit anything from his parent.

What should you be doing?
If you have not already done so, you should review any offshore structure which owns UK residential property to see whether it will be caught by the new rules and, if so, when any inheritance tax charges are likely to arise.

You will now also need to review whether you have any offshore structures which have made loans or provided security for loans which have been used in relation to UK residential property or whether you, as an individual, have made any such loans or provided any such collateral.

Where a property owning structure is caught by the new rules, it will no longer provide any inheritance tax benefits. If the annual tax on enveloped dwellings is payable, there will be a strong case for dismantling the structure although this may well come at a tax cost.

There will be capital gains tax to pay on any increase in value since the property came within the Annual Tax on Enveloped Dwellings (ATED) regime, as well as possible UK capital gains tax on gains relating to earlier periods if the owner is UK resident. If there are loans secured on the property, there could also be stamp duty land tax unless care is taken.

The government has made it clear that there will be no relief from these tax liabilities.

You will therefore need to take advice as to what tax liabilities might arise and then weigh up the benefits of terminating the structure (no longer having to pay the ATED charge) against the upfront tax cost.

Where properties held through offshore structures are not within the ATED regime, there may be no disadvantage in retaining the existing structure. Indeed there may be some benefits as the rate of capital gains tax for offshore companies is lower than for individuals and funding the company with debt minimises UK tax on the rental income.

You will need to keep an eye on this last point as there was a consultation launched at the time of the 2017 Budget as to whether offshore companies should come within the scope of UK corporation tax (and therefore the rules which apply for corporation tax purposes to limit the availability of interest relief).

Loans and collateral will need special attention given the scope for increased tax charges.

In some situations it will be worth exploring whether connected party debt can be replaced with bank debt.

Where a loan is secured on offshore assets either as well as or instead of the property itself, the feasibility of securing the loan on the property alone should be discussed with the lender or with alternative lenders.

How can I protect myself against inheritence tax on UK residential property going forward?

The proposed new legislation is widely drawn and, in the future, it will be difficult to avoid paying UK inheritance tax on UK residential property. There are however a number of relatively straightforward ways of mitigating (but not necessarily eliminating) any tax liability:

— Lifetime gifts to the next generation – but only if the parents do not live in the property or pay a market rent.

— For a married couple, using the spouse exemption on the first death, possibly coupled with a subsequent gift to the next generation.

— Life insurance – relatively cheap in the early years but this can become quite expensive once the owner gets older and so may not be a long-term solution. It is, however, a good solution for younger non-domiciliaries who will in due course leave the UK and then sell the property.

— A loan secured on the property to purchase or improve the property. Any growth in value will of course still be subject to inheritance tax.

— Where investment properties are being purchased, using a widely held company (i.e. getting together with other investors) will avoid any inheritance tax exposure.

We will no doubt see other, more complex, suggestions for the ownership of UK residential property. However, given the targeted anti-avoidance rule, any proposals will need to be examined carefully if one of the benefits is said to be freedom from UK inheritance tax.

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