OPEN THE ENVELOPE?

Mark Davies, **Jon Elphick** and **Nick Beresford** consider the pros and cons of de-enveloping UK residential property

KEY POINTS

What is the issue? Further changes are being introduced that will result in offshore structures owning UK residential property becoming less attractive from a tax perspective.

What does it mean for me? These structures need to be reviewed to ensure they remain fit for purpose.

What can I take away? Advisors need to ensure that the tax liabilities arising are commensurate to the benefit of retaining or unwinding existing structures.

The UK tax regime for non-residents and non-natural persons owning UK residential property has evolved rapidly in recent years. The most significant changes have been the introduction of the annual tax on enveloped dwellings (ATED) along with ATED-related capital gains tax (ATED CGT), the increase in the stamp duty land tax (SDLT) rates for residential property acquired by non-natural persons, and latterly the extension of CGT to non-residents (NRCGT) from 1 April 2015.

In a further move against use of corporate envelopes, the government announced in the summer Budget 2015 that it intends to expand IHT charges to UK residential property owned by offshore companies either directly or though excluded property trusts. The new rules are intended to have effect from 6 April 2017. HMRC's technical briefing, released on 8 July 2015, suggests new legislation will ensure: '... that shares of offshore companies or similar structures are not excluded property to the extent that they derive their value directly or indirectly from UK residential property... or to the extent that the value of those shares is otherwise attributable to UK residential property.'[1]

The planned IHT changes may be the last straw for individuals with UK properties owned within offshore structures, and many may now consider de-enveloping. The government has undertaken to consider the costs of de-enveloping when legislating on this new charge.

Clients would now be well advised to review their current arrangements and ascertain if de-enveloping may be appropriate. It is important that this review also considers any non-tax benefits of the structure, such as confidentiality, asset protection and succession planning.

CASE STUDY

Consider the case of Felipe, a Brazilian national who is UK tax resident in accordance with the statutory residence test and is non-UK domiciled. He is not deemed UK domiciled for IHT purposes. Felipe is the settlor and a beneficiary of the Fortuna Trust, a discretionary trust whose forum of administration is Guernsey, and which is an excluded property trust for UK IHT purposes. The trust was established in 2010. Felipe is single with no children.

The trust owns 100 per cent of the issued share capital in Fortuna Ltd, a BVI company. The company owns residential property in London purchased in 2010 for GBP8 million, with a current market value of GBP12 million. The property was valued at GBP10 million on 5 April 2013 for ATED CGT purposes by a registered surveyor.

The property is used as a private residence by Felipe. The company has no bank debt and the initial purchase price was funded by way of share subscription by the trust. The company and trust do not own any other assets.

As the structure currently stands, the main tax implications are:

- **the company will be subject to a yearly ATED charge of GBP109,050 (increasing annually in line with the Consumer Price Index (CPI));**
- **on any future disposal of the property, the company will be subject to ATED CGT at 28 per cent on the difference between the 5 April 2013 market value and the sale price (as the property is held by a company, private residence relief (PRR) will not be available); and**
- **the trust currently holds excluded property (the shares in an offshore company and the debt due from the offshore company) but, on introduction of the extended IHT regime, the trust will be treated as owning the UK residential property and, thus, will become subject to the relevant property regime (in particular, the ten-yearly anniversary and exit charges).**

DE-ENVELOPING OPTIONS

Felipe is concerned about the increasing tax costs of maintaining the offshore company and trust structure. He is also concerned about the government's IHT proposals, which could adversely affect the most significant remaining tax advantage of the structure. He asks if there is a way to restructure, to reduce ongoing tax costs.

Felipe could consider de-enveloping and owning the property in his own name. A common option (but not the only one) could be to liquidate the company, transfer the property to the trust as an *in specie* distribution and then appoint the property to Felipe as a trust beneficiary. The process of de-enveloping in this fashion will have the following implications:

- **Liquidating the company will result in a deemed disposal of the property at its current market value of GBP12**

million. An ATED CGT charge at 28 per cent will be levied on the gain of GBP2 million accrued between 5 April 2013 and the present. The ATED CGT cost would be GBP560,000;

- **no SDLT should be payable if the transfer of the property is correctly structured as a distribution *in specie* to the trust;**
- **the trust will crystallise gains of GBP2 million on the liquidation of the company (this assumes the increase in the value of the property is reflected in a corresponding increase in the share value);**
- **the crystallised gains in the trust can be matched to the 'capital payments' obtained by Felipe (i.e. the benefit of his rent-free occupation of the property, together with the capital receipt of the property). Essentially the gains of GBP2 million derived by the trustees will be attributed to Felipe and taxed at 28 per cent (s87 *Taxation of Chargeable Gains Act 1992* (TCGA 1992)), creating an additional CGT liability of GBP560,000; and**
- **Felipe will not be able to shelter the capital payments from UK taxation by claiming the remittance basis, as the capital payments have been enjoyed and received in the UK.**

After de-enveloping, personal ownership by Felipe will mean:

- **the property will no longer be subject to the ATED or ATED CGT regimes as it is held by a natural person;**
- **Felipe will, prima facie, be subject to a CGT charge in the future, but he can claim PRR to the extent the property remains his sole or main residence;**
- **the property will be rebased to its market value of GBP12 million when it is appointed from the trust to Felipe. This is advantageous if Felipe cannot claim PRR in the future (if, for example, the property ceases to be Felipe's sole or main residence); and**
- **the obvious downside is that the property will form part of Felipe's estate for IHT purposes and will be liable for IHT at 40 per cent, subject to the current nil-rate band (NRB) of GBP325,000, and the newly announced 'main residence nil-rate band' (starting at GBP100,000 from 6 April 2017). Felipe could choose to manage this cost by obtaining life insurance.**

While a client's specific circumstances should always be considered, there will generally be unavoidable tax outcomes of de-enveloping most offshore company and trust structures (namely the crystallisation of ATED CGT and matching of trust gains with capital payments to beneficiaries).

In all cases, extreme caution should be taken to ensure the property is extracted without incurring an SDLT charge.

COST-BENEFIT COMPARISON

Advisors will need to make a comprehensive cost-benefit comparison of de-enveloping versus retaining the structure. For example, consider the position if Felipe retains his current structure, but dies unexpectedly in 2020, when the property has grown in value to GBP13.5 million. In this case:

- **Annual ATED charges of GBP545,250 (based on current rates and excluding any CPI increases) would have been payable in the five years from 2015 to 2020;**
- **there would be an exposure to ATED CGT if the property is sold; however, it is likely that Felipe can escape a charge to CGT on capital payments accumulated by virtue of s87 TCGA 1992, subject to careful planning;**
- **based on the government's IHT proposals, the shares in the company would no longer constitute excluded property. Based on HMRC's initial consultation document, this is likely to mean the trust will become subject to ten-yearly anniversary charges at 6 per cent of the property value in 2020, along with potential exit charges if the property is distributed. Note that IHT charges could be avoided if the property is sold before 2020 and the proceeds are retained offshore.**

Compare this to the position if Felipe had decided to restructure in 2015:

- **he would have triggered an immediate tax liability of GBP1.12 million due to ATED CGT and the rules in s87 TCGA 1992 applying on the distribution of the property to him;**
- **he would have avoided the cash-flow impact of five years of ATED charges;**
- **he would have sheltered post-restructure gains from UK tax by claiming PRR; and**
- **the property would form part of his estate for IHT purposes, leading to IHT charges of GBP5.4 million, which could be mitigated by the NRB and main residence NRB.**

As shown, Felipe would be in a worse position if he restructured in 2015. He will have avoided ATED charges of GBP545,250 and sheltered post-restructure gains from CGT. However, on his death, he would be subject to an immediate 40 per cent IHT charge on the value of the property, compared to the more favourable relevant property rules, which would impose ten-yearly anniversary and exit charges on the trust. Plus, Felipe's immediate CGT liability of GBP1.12 million compares unfavourably to the saving in annual ATED charges.

> **"Advisors must make a full cost-benefit comparison of de-enveloping versus retaining the structure"**

While, in the above scenario, Felipe would have been better off had he not restructured in 2015, consider the case if Felipe was married and died 20 years after restructuring instead of after five years. In this case, Felipe could mitigate IHT completely using the spousal transfer exemption. Furthermore, there would have been a far larger annual ATED saving over time that would, with the benefit of hindsight, outweigh the upfront CGT costs.

CONCLUSION

Ownership of UK residential property through offshore structures is becoming increasingly unattractive. As the above examples show, personal ownership of residential property may in some circumstances be more advantageous than trust and company structures in future, given the proposed application of IHT charges to excluded property trusts.

More broadly, the current government has tax planning squarely in its cross hairs. Individuals using offshore structures are doing so in an uncertain political environment, as shown by legislative changes such as the 50 per cent increase in ATED rates in the *Finance Act 2015*.

As a result, advisors need to work with clients to review the suitability of their offshore structures. De-enveloping may be advantageous but should only be considered after a careful cost-benefit analysis, and all of the client's current circumstances and plans have been considered.

Notwithstanding the above, the non-tax advantages and the original rationale for the structure's establishment should not be ignored. It may be that confidentiality, asset protection and succession planning provide compelling reasons against de-enveloping.

1 *Technical briefing on foreign domiciled persons/ inheritance tax residential property changes*



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