The Offshore & International Taxation Review

NON DOMICILED INDIVIDUALS BUYING PROPERTY IN THE UK

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This article considers tax efficient ways for non domiciled individuals to buy property in the UK. I have categorized non domiciliaries by residence, ordinary residence and the likelihood of becoming deemed domiciled. The categories are not exhaustive but I hope that they cover most cases. Within each category, I have tried to identify the factors that will determine the best option from a tax perspective. The discussion is cumulative: the main points are raised under the first two headings and only the relevant differences are mentioned under the later ones.

1. Non resident, non ordinarily resident and status unlikely to change

1.1 Direct Ownership

The only direct taxes that will apply are inheritance tax and, if the property is let, income tax. Being neither resident nor ordinarily resident, this individual is outside the scope of capital gains tax. However, it is important to check that any gain realized on a disposal of the property will be chargeable to capital gains tax and not to income tax. This involves finding out why he wants to buy the property, bearing in mind that he is evidently not planning to spend very much time in it. He may simply want somewhere to spend the few weeks a year that he is here, or he may be investing for rental income, or a combination of the two. In that case, there is no problem. Problems arise if he is trading in property - and this is possible even if he only ever deals in one property - or if his sole or main object is to realize a gain on the sale of the property, bringing him within ICTA 1988 section 776.

Income tax on rental income will be payable at the individual's personal rates. Generally, personal allowances will not be available to a non resident unless he falls within ICTA 1988 section 278(2) or is entitled to personal allowances under the terms of an applicable double tax treaty. Inheritance tax will be payable if he dies

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whilst owning the property, or gives it away, but only if and to the extent that its value - added, in the case of death, to the value of any other UK situs property - exceeds the nil rate band. If the rental income is not expected be substantial, and the total value of UK situs property not significantly above the nil rate band, then it may be unnecessary to do anything.

1.2 Alternatives

There are four main alternatives. First, take out a fixed term life insurance policy to protect against inheritance tax. Secondly, buy the property with a mortgage. Thirdly, set up an offshore company. Fourthly, use a non resident discretionary trust.

1.2.1 Life Insurance

A fixed term life insurance policy deals with the inheritance tax risk but not the income tax problem. It will be most suitable for an individual who is not expecting to receive much by way of rental income, but whose UK property will be worth more than the nil rate band. The term of the insurance should be as close as possible to the expected period of ownership of the property. On expiry, it can be renewed if appropriate.

1.2.2 Mortgage

If the property is bought with a mortgage, both the inheritance tax exposure and the income tax liability will be reduced. The amount outstanding on the mortgage will reduce the value of the individual's UK estate for inheritance tax purposes. This will be true even if the lender is not UK resident, provided that the loan is secured on the property[2]. However, if the property increases substantially in value, the equity may sooner or later exceed the available nil rate band. This will be of particular concern if the individual has other UK situs property which has already consumed most of the nil rate band. Even if the property does not increase in value, the equity and therefore inheritance tax exposure will increase as the mortgage is paid off. Therefore, a mortgage may not give sufficient protection if the property is to be owned for a significant period.

For income tax purposes, the interest on the mortgage used to acquire the property can be deducted from rental income in computing the individual's profits of his Schedule A business. The principles of deductibility are now broadly equivalent to those applicable to Schedule D Case I. If the individual occupies the property for part of the year, or it is unavailable for letting for some other purpose, then only the

[2] IHTA 1984 section 162(5)(b).

appropriate proportion of the interest will be deductible, computed on a time basis[3].

1.2.3 Offshore Company

Superficially, the offshore company route is an attractive option. If the shares are situated outside the UK, then they are outside the scope of inheritance tax. If the company is not UK resident, and is not carrying on business through a branch or agency in the UK, then it will not pay corporation tax on its rental income. It will pay income tax at the basic rate only. If the company buys the property with a mortgage, it can deduct interest from its rental income (as discussed above) in computing its taxable profits. At first sight, the only downside is the cost of running the company. But in reality there are significant risks. These were dramatically illustrated by the decision of the Court of Appeal in *R v Dimsey; R v Allen*[4]. This has been appealed to the House of Lords and any planning in this area should, ideally, be postponed until judgment is given.

There are two principal risks. The first is that the shareholder is a shadow director whose rent free occupation of the property is an emolument taxable under Schedule E. The second is that the company is resident in the UK. The first risk follows from the decision in *R v Dimsey; R v Allen* that a shadow director within ICTA 1988 section 168(8) is an office holder for the purposes of sections 145 and 146. A shadow director is someone in accordance with whose instructions the directors are accustomed to act. The value of his rent free occupation is treated as an emolument taxable under Schedule E.

At the outset, this individual needs to decide whether to make absolutely certain that he is not a shadow director, or whether to accept that he is a director and mitigate the tax liability. To avoid being a shadow director, he needs to ensure that there is an independent board of directors who do not take instructions from him. These directors must not simply ratify suggestions made by the shareholder. They must take decisions independently. Unless they disagree with the shareholder and reject his ideas from time to time, this will be difficult to prove. From the adviser's point of view, you must ensure that the client is prepared cede control of the company to independent directors without interfering and that he will stick to this throughout the lifetime of the arrangement.

If he is not prepared to do this, he may be able to accept he is a director but mitigate the income tax liability in one of two ways. First, he can try to ensure that most of his emoluments (the value of the rent free occupation) are attributable to duties

3 SAT1 (1995) para 9.153.

4 [1999] STC 846.

performed outside the UK. As a non resident, he will not be taxable on these foreign emoluments. This can be achieved by performing substantial duties outside the UK, such as attending board meetings etc. Whilst it may not be possible to avoid performing *any* duties within the UK - decorating or repairs may be considered duties - it should be possible to keep these to a minimum. There is a risk that the Revenue will argue that the emoluments are exclusively referable to the UK duties, but this risk can be minimized by suitably drafted contracts between the individual and the company.

The second mitigation strategy is to pay a market rent for the period of occupation. Given that we are talking about a non resident, the periods of occupation will be relatively short. If the property cost £75,000 or less, then the true cost of paying the market rent would only be the basic rate income tax payable by the company. However, for properties costing more than £75,000, ICTA 1988 section 146 treats the occupier as receiving emoluments equal to the appropriate percentage of so much of the cost as exceeds £75,000. The appropriate percentage is the official rate of interest - currently 6.25 per cent. This can lead to a significant charge: on a property worth £1,000,000 a 40% taxpayer would have an annual tax charge of £23,125 under this provision. It is possible to avoid this charge using two separate trusts.

The second risk of an offshore company is that it becomes UK resident. If this risk materializes, there are very serious income and corporation tax consequences. The company will be subject to corporation tax on its Schedule A profits and on any chargeable gains it realizes. This is particularly unfortunate for a non resident shareholder who would himself have been outside the scope of capital gains tax. There will also be a Schedule F charge on dividends or distributions that are not specifically excluded from income tax. In contrast, if the company is non resident, there is no UK tax charge on dividends or distributions to a non resident shareholder. Additionally, even if the shareholder has avoided being a shadow director, he will become taxable on the value of his rent free occupation under ICTA 1988 section 418 if the company is resident, assuming that it is a close company.

To avoid this scenario, first, of course, the shares must be registered outside the UK. Secondly, there must be absolutely no possibility of the company's central management or control being in the UK. Board meetings must take place outside the UK. Major decisions should be taken at these meetings and they should be properly minuted. The shareholder must not take any remotely significant decisions or actions in relation to the company whilst in the UK. He may be on the board - although see the discussion above in relation to sections 145 and 146 - but he must only perform his duties as director whilst outside the UK.

It may be possible to reduce both of the above risks if the shares are held by non resident trustees instead of by the individual but this is by no means automatic. Whether central management and control is exercised in the UK and whether the individual is a shadow director are both questions of fact. The interposition of trustees will not itself affect the answer to either question. If the individual takes management decisions, which are effectively conveyed to the board by the trustees, the results will be just as disastrous as if the individual had given instructions to the directors himself. In theory, the trustees may hear suggestions from the individual, then make an independent decision as to whether or not to instruct the directors accordingly. In practice, if the individual's suggestions are invariably adopted, it will be difficult to demonstrate that the trustees' decision is truly independent. The best advice is always to ensure that the individual only makes suggestions outside the UK and - if he does not want to be a shadow director - that he does not make them at all.

1.2.4 Non Resident Discretionary Trust

If the period of ownership is likely to be less than ten years, then a non resident discretionary trust can be used to protect the property from inheritance tax. This has to be done carefully, because UK situs property is not excluded property. The easy way of making it excluded property is to put it into a company whose shares are situated outside the UK. However, the following strategy avoids the use of a company and its associated risks.

First, the settlor settles offshore cash on non resident trustees on discretionary trusts. Because the cash is situated outside the UK, the settlement does not create an inheritance tax charge. Secondly, the trustees buy the UK property with the cash - and a mortgage, if there will be rental income from which the interest can be deducted. Within ten years of the creation of the trust, the property should be sold and the proceeds taken offshore. There is no exit charge because the property ceases to be relevant property simply by becoming excluded property. Once the property is offshore, it is not relevant property for ten yearly charge purposes and it can be freely distributed to beneficiaries without an exit charge.

During the lifetime of this arrangement, there will be no TCGA 1992 section 87 charge on the non domiciled individual's rent free occupation because of his non domiciled status. Similarly, section 86 will not apply. There will be no ICTA 1988 section 739 or 740 charge because this individual is not ordinarily resident, but there is likely to be a charge under section 660A on the individual in relation to income arising to the trustees.

2. Resident but Not Ordinarily Resident

The major difference between this individual and the last one is capital gains tax. Being resident, he is within its scope – unless principal private residence relief is available. A minor difference is that, if he uses an offshore company and is a shadow director, he will be taxable on the whole of the emoluments he receives and not just on the part that is attributable to duties in the UK.

2.1 Direct Ownership

It is unlikely that this individual will be resident for long. Clearly that is not his intention, otherwise he would be ordinarily resident. If he is confident that this will not change, he could restrict his capital gains tax planning to postponing sale of the property until the tax year after his residence here has ceased.

Alternatively, if at any point he will be occupying the property as his only or main residence, he could rely on principal private residence relief. However, if the property is let earlier than the last 36 months of ownership, the relief will be limited.

If postponement of sale or principal private residence relief provides a sufficient answer to the capital gains tax problem, then only income tax on rental income and inheritance tax remain to be dealt with. The circumstances in which a mortgage or life insurance will be suitable are essentially the same as those discussed above.

2.2 Alternatives

If neither postponing sale nor principal private residence relief will give adequate protection from capital gains tax, then a non resident company or a non resident trust should be considered. If the property is bought by either of these vehicles, then it will be outside the scope of capital gains tax.

2.2.1 Offshore Company

The use of an offshore company can achieve the same income tax and inheritance tax benefits for this individual as for the last. It also takes the property outside the scope of capital gains tax. If the individual disposes of his shares in the company and those shares are situated outside the UK, he will be entitled to relief from capital gains tax provided that he does not remit the proceeds. An income distribution by the company will escape a Schedule D Case V charge if it is not remitted.

However, as before, it is absolutely crucial to ensure that the company does not become UK resident. It is also advisable in most cases to ensure that the individual is not a shadow director. He can accept that he is a shadow director and pay a market rent for his occupation in order to avoid a schedule E charge, but basic rate tax will have to be accounted for, and possibly the additional charge under section 146. The option discussed in relation to a non resident individual of attributing emoluments to foreign duties is not available to a resident individual. The resident individual is taxable on foreign emoluments under Schedule E Case III. Although the charge is limited to emoluments that are remitted, the Revenue consider that rent free occupation of a UK property inevitably involves a remittance.

2.2.2 Offshore Company and Non Resident Trust

Putting the shares into a non resident trust creates a cosmetic distance between the individual and the company. The idea is to give added protection against the company being UK resident or the individual being a shadow director. However, as before, unless in substance central management and control of the company are outside the UK and the company's directors do not act on the instructions of the individual, the arrangement will not give this protection.

Using a non resident trust also means that if the company sells the property and is liquidated or sold, the capital gains can be remitted by the trustees to the individual without a charge to capital gains tax. As a non domiciliary, the individual is outside TCGA 1992 section 87. For income tax purposes, he is outside ICTA 1988 sections 739 and 740 because he is non ordinarily resident but, if income arises to the trustees – as distinct from the company – this will be treated as his under ICTA 1988 section 660A and taxable if remitted.

2.2.3 Non Resident Discretionary Trust

A non resident trust alone will protect against capital gains tax, but not income tax or (subject to what is said below) inheritance tax. The capital gains tax protection is better than that provided by a company (used alone) because the proceeds of any sale can be remitted to the individual in the UK. A trust is also much less risky than a company. As discussed previously, a non resident discretionary trust can in fact be used to protect the property from inheritance tax if the expected period of ownership is less than ten years. Briefly, this involves settling non UK situated cash on trustees who then acquire the property, with or without a mortgage. Once the property is sold, the proceeds can be taken offshore, thereby becoming excluded property and ceasing to be relevant property. There is no exit charge on this event and, provided the trust property is offshore by the ten year anniversary, there should be no ten yearly charge.

3. Resident, Ordinarily Resident and Not Likely to Become Deemed Domiciled

Ordinary residence brings this individual within the scope of ICTA 1988 section 739. In most cases, there will have been a transfer of assets by virtue or in consequence of which income has arisen to persons resident or domiciled outside the UK and it will not be possible to establish a motive defence - although this should of course be considered in appropriate cases. The recipient of the income will typically be the non resident company or the non resident trustees. That income will be attributed to the ordinarily resident individual and taxable at his personal rates.

The longer the period of residence the more seriously a company needs to be considered in order to obtain inheritance tax protection. Mortgages, life assurance and discretionary trust arrangements are all relatively short term options. They can be adapted for the longer term but the complications increase. Interest only mortgages and/or regular remortgages can slow down the increase in the equity in the property. Life assurance policies can be put in trust for the individual's intended heirs and the premiums paid using the normal expenditure out of income exemption. Trustees of discretionary trusts can sell the property and take the funds offshore before the ten year anniversary, possibly repurchasing the same or a different property later. The company route avoids the complications but is also hazardous for the reasons discussed at 1.2.3, 2.2.1 and 2.2.2.

4. Resident, Ordinarily Resident and Likely to Become Deemed Domiciled

The crucial point here is that shares in an offshore company held directly by an individual will cease to be excluded property once that individual becomes UK domiciled for inheritance tax purposes, i.e. deemed domiciled. If a company is used, its shares should be held in a non resident trust. Whilst non UK situated assets held by an individual are only excluded property if the individual is non domiciled at the time the question arises, non UK situated assets held in trust are excluded property if the settlor was non domiciled when he created the settlement. Subsequent changes in domicile (deemed or otherwise) will not affect the excluded property status of the trust property.

If a company is considered undesirable in a particular case on account of the risks, then a non resident trust on its own should be considered for the capital gains tax benefits if there is doubt over the likely availability of principal private residence relief. The individual's deemed domicile will not affect the capital gains tax benefits: deemed domicile is only relevant to inheritance tax.

5. Conclusions

The possible circumstances are so varied that it is difficult to make helpful generalizations. One that I would like to make concerns the use of offshore companies for inheritance tax protection. These are often considered the only option. Sometimes this is true, but life insurance, mortgages and discretionary trusts (used as discussed at 1.2.4) tend to be underrated. In many cases they are safer and cheaper solutions than a company. Finally, the House of Lords will soon be hearing the appeal in *R v Dimsey; R v Allen*. Until their decision is available, planning in this area should be postponed if possible.