IHT ON INDIRECTLY HELD UK RESIDENCES

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The Finance (No 2) Bill 2017-19 proposes changes in the inheritance tax treatment of UK residential property. The proposals have been subject to extensive comment and consultation and it is reasonable to expect that they will be enacted (in due course) without any material revision.

It is proposed that they will be introduced with effect from 6th April 2017. There is no indication that there will be any relief for an individual who died after 5th April 2017 but before the new rules are enacted. Will they really retrospectively impose a charge to tax on somebody who has already died?

Under the present rules, UK residential properties are protected from the scope of inheritance tax if they are held by foreign incorporated companies. The shares in the company are foreign assets and are excluded property for the purposes of the inheritance tax in the hands of a foreign domiciled person: see section 6(1) IHTA 1984.

The shares will also be excluded property in the hands of the trustees of a settlement if the settlor was not UK domiciled at the time the settlement was made: see s.48(3) IHTA 1984.

This excluded property status applies even though the company may hold UK property.

However, this analysis is going to change from effect from 6th April 2017 as far as UK residential property is concerned. From that date, the shares in the foreign company will cease to be excluded property to the extent that their value is directly or indirectly attributable to UK residential property: see draft Schedule A1(2) IHTA 1984.

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Also the shares in the foreign company will not treated as excluded property to the extent that the value of the shares is attributable to relevant loans: see draft Schedule A1 para 2(2)(b)(iii).

This denial of excluded property status extends to the rights and interests of participators (which includes a loan creditor) in the close company: see draft Schedule para A1(9)(1).

The definition of residential property is taken from the non-residents capital gains tax definition in schedule B1(2) TCGA 1992 being an interest in land which consists of a dwelling. This includes buildings used or suitable for use as dwellings and buildings in the course of being constructed as dwellings or adapted for use as dwellings and the grounds in which such buildings are situated.

Where the property has mixed use it is only the residential part which is within the new rules.

These changes were first announced in a technical paper in 2015. They found their way into draft clauses in December 2016, with some more draft clauses in the Finance Bill 2017 on 20th March with a further incarnation on 13th July 2017. it remains to be seen whether any further amendments will take place during its passage through Parliament.

This is not a transparency rule. The UK residential property is not treated as the property of the shareholder – it is the value of the shares in the company which is affected.

There are some valuation issues here because the value of the shares in the company would not necessarily correspond with the value of the underlying company's assets – and in particular the UK residential property. However, the essential point is that the value of the UK residential property will in principle be bought into the scope of inheritance tax.

The liability to inheritance tax is that of the shareholder or participator. The shareholder holds the shares and will be liable to inheritance tax to the extent that their value is attributable to the UK residential property. In the event that the shares are held by trustees, two possible charges arise. If the settlor of the trust is capable of benefiting from the trust, the reservation of benefits provisions in s102 FA 1986 may apply to cause the value attributable to the UK residential property to form part of their estate for inheritance tax purposes in the event of their death.
In addition, and entirely separately, the ten year charge may apply so that on each tenth anniversary, a charge to inheritance tax would arise (probably at a rate of

6%) on the value of the non-excluded property. A similar charge would arise on a proportionate basis in the event of any removal of the assets from the trust.

HMRC will clearly have a difficulty in trying to collect inheritance tax from non-resident and non-domiciled individuals who do not have any UK assets – merely having some foreign assets deemed to be within the scope of UK inheritance tax. This is clearly a matter which will need to be considered. The proposed solution is for HMRC to place a charge on the UK property owned by the company so that no sale could take place without the inheritance tax issues being fully examined and satisfied. There is existing authority for the imposition of an Inland Revenue Charge on property for inheritance tax purposes under s237 IHTA 1984 and the proposal is that this charge be extended to enable HMRC to be protected.

It is likely that HMRC will have sufficient information to enable such charges to be registered because the Land Registry would disclose that the UK residential property is owned by a foreign company. In the same way that they have made investigations into companies which may be subject to the ATED charge, HMRC could use the same data to impose a charge to protect their inheritance tax position.

It is not clear how this will provide any protection for HMRC in respect of the charge on relevant loans or during the two year "tail".

Partnerships

The provisions apply similarly to partnerships if and to the extent that the value of the interest is directly or indirectly attributable to a UK residential property interest: see draft Schedule A1(2)

A partnership for this purpose includes those under the Partnership Act 1890, the Limited Partnerships Act 1907, the LLP Act 2000 as well as:

> *"A firm or entity of similar character [to the above] formed under the law of a country or territory outside the UK":* see draft Schedule A1(10)(d)

Valuation

An argument will often arise that the value of the shares in the close company may not be affected (or not significantly affected) by the existence of the UK residential property. In that case, no part of the value of the shares would be attributable to the UK residential property and no inheritance tax would therefore arise.

One way to look at this point is to consider whether the value of the company's shares would be any less if the UK residential property did not exist. Where the property is held in a significant trading company it is quite possible that the company's shares could be based on its trading operations, revenues and profitability (and more specifically the anticipated revenues and profitability for the future) and not be affected by the existence (or otherwise) of assets of this nature. We are all familiar with the concept of companies being valued at below their asset value

However, it is probable that in most cases the existence of the UK residential property will have some effect on the value of the shares – if the company owns a £1m property in the UK, that is likely to have some effect on the overall value of the shares. However, that may not the case if the property was encumbered by loans.

There is another reason why the new rules may have no application in more significant cases. One can imagine a group structure of a substantial trading concern which has a distant subsidiary with a valuable UK property. The value of the UK property would be traced up to the value of the holding company shares and to the extent that that value is reflected in those shares, it would be within the scope of inheritance tax notwithstanding that the shareholders (and the whole of the group) has nothing to do with the UK and that the shareholders may be neither resident nor domiciled in the UK. They would still be liable to inheritance tax by reason of the existence of this property.

This will be a particular worry to foreign trustees who are holding the parent company's shares as they may not be aware that in some distant subsidiary, there is a UK residential property – but they will still be liable for the tax.

The draft legislation contains an exemption from these rules below a value threshold. Paragraph 2(3) of the draft schedule A1 provides that you disregard:

> *"an interest in a close company, if the value of the interest is less than 5% of the total value of all the interests in the close company".*

A right or interest in a close company will usually be a reference to the shares in the company, although it includes the rights and interests of participators (which includes a loan creditor) in the close company: see draft Schedule A1(9)(1).

The close company in question is not necessarily the company owning the UK residential property. It will be the shares held by the individual or trustees which will be potentially (and possibly partially) disqualified from excluded property status on 6th April 2017.

It is important to note that paragraph 2(3) does not refer to a shareholder with less than a 5% interest in the company. The 5% refers to the value of the interest in the close company which is attributable to the shares of the shareholder in that company.

Schedule A1(2) applies to an interest in the close company "if and to the extent that the interest meets the condition in subparagraph 2". The condition in subparagraph 2 is that the value of the interest is attributable to a UK property interest by virtue of an interest in a close company.

My interpretation of this provision is as follows, although others have different interpretations. Paragraph 9 says that "references to an interest in a close company are to the rights and interests that a participator in a close company has in that company" and paragraph 2(3) requires you to "disregard an interest in a close company if the value of the interest is less than 5% of the total of all the interests in the close company".

Paragraph 2 might therefore be rewritten substituting the words "the rights and interests that a participator in a close company has in that company" for the words "an interest in the close company" and it would read as under:

> "disregard the rights and interest that the participator [in a close company] has in that company if the value of the rights and interests that the participator [in a close company] has in that company is less than 5% of the total of all the rights and interests that the participator [in a close company] has in that company".

If it was the intention to exclude shareholders with less than 5% of the shares in the company, there would be no need to make any reference to the value. Furthermore, one would expect entirely different wording, consistent with the many other references to 5% shareholdings which exist throughout the tax code.

Accordingly, I have taken the view that it is necessary to look at the value of the holding company shares which are held by the participator (being the individual or the trustees) and to see whether the value of the UK residential property attributable to those shares is less than 5% of the value of those shares. If it is, then the new rules can be disregarded and inheritance tax under the new provisions will not arise.

To take an example, the trustees of a settlement own all the shares in a holding company worth (say) £50m and there is a subsidiary which holds a UK residential property with a net value of £2m. If we assume (although for the reasons set out above it is not necessarily the case) that £2m of value is attributable to the shares in the holding company, that would be the value which was not excluded property and therefore subject to inheritance tax either on the settlor or on the trustees by way of ten year or exit charges. However, if the value of the interest in the company were £50m and the value of the underlying residential property is £2m, that is less than 5% and the new provisions can be disregarded.

It may not be quite so simple. There may be (say) four individual shareholders each owning 25% of the company. Each of them may have excluded property – and will be concerned that part of the value of their shares will be vulnerable to inheritance tax because that part would not be excluded property. The valuation issues would be rather different, but the result should be broadly the same. Each of the shareholders with 25% of the holding company, would not normally be regarded as holding shares worth 25% of £50m (although see the recent decision in *Cosmetic Warriors Ltd v Andrew Gerrie [2017] EWCA Civ 324*). In any event, the value attributable to the minority shareholdings would be correspondingly reduced and the 5% threshold should still not be exceeded.

The position is likely to be affected by the existence of any loans against the UK property – see further below.

We will no doubt have HMRC guidance on the 5% disregard in due course and it will be interesting to see its interpretation of this ambiguous provision.

Trustees

Trustees holding UK residential property directly are not affected by these new rules. Even if the trust was established by a foreign domiciled settlor, the UK residential property would not be excluded property as it is situated in the UK. Accordingly, the new rules do not need to catch it – it is already caught.

Trustees will be affected if they hold the UK property through a foreign company which would have been excluded property. They will no longer be holding excluded property to that extent, thereby exposing them to the ten year charge or exit charges – or indeed, in the event that the settlor has a reservation of benefit, in the event of his death.

When considering the ten year charge applicable to a trust which is caught by these provisions, the charge will only apply for the period during which the property was not excluded property. Accordingly, this is likely to be the time from 6th April 2017 to the date of charge: see section 68(3) IHTA 1984.

The position may also be affected by the existence of loans.

Loans

The original proposals were that loans from connected persons would not be deductible from the value of the UK residential property but that idea has been replaced by a separate charge on the loans themselves. The The loan may not of course be deductible anyway if it is to a person resident outside the UK, not falling to be discharged in the UK and unsecured (IHTA 1984 s 162(5)) but the new provisions will apply to charge inheritance tax on the loan itself by causing the loan to be regarded as non-excluded property.

A loan includes an acknowledgement of a debt for example, leaving the purchase price outstanding as an IOU and it is irrelevant that the loan may be on commercial terms.

Where a loan is made for the purpose of acquiring, maintaining or improving UK residential property and is used for that purpose, the loan itself is regarded as UK property and not excluded property. Similarly, the provisions will also apply to loans used to acquire an interest in a close company (or partnership) which uses the money for the same purpose.

The rules apply equally to money or money's worth made available as security, collateral or guarantee for a relevant loan.

These rules can have the effect of multiplying the value chargeable. Assume for example that an individual has borrowed money from a bank overseas to buy a UK property. An offshore trust of which he is the settlor gives the bank security for the loan over its assets. As mentioned above the loan may not be deductible as the bank does not need to secure it on the UK property but now in addition the assets in the trust held as security will no longer qualify as excluded property and will therefore be subject to the 10 year charge, and worse still will be within the reservation of benefit provisions.

There is a two year tail – that is to say, the exposure to tax under these new rules will continue to apply for a period of 2 years after the conditions have ceased to be fulfilled. Even when the loan is repaid, it will be two years before the loan ceases to be excluded property.

The two year tail applies to the affected property – the property which is deemed not to be excluded property. Where that is the shares in a company, if the company sells the property, that will not be within the 2 year tail and the shares would immediately resume their status as excluded property.

These rules can give rise to the absurd situation that a person in Brazil (who has never had anything to do with the UK nor has ever any assets in the UK and does not even speak the language and has never been to the UK) lends some money to a friend in his town. The friend uses the money to purchase a property in the UK. He subsequently sells the UK property and repays the loan. If the lender were to die within two years, there would be a charge to inheritance tax in respect of that loan. The conditions for the charge would be clearly satisfied.

The fact that there is no mechanism for notifying HMRC or any reason why this non-resident, non-domiciled, non-English speaking person should ever think he has any UK liability, is irrelevant. And the fact that HMRC may find the tax difficult to collect is also irrelevant: see *Agassi v Robinson 77 TC 686*. However, either there is a liability or there isn't – and if there is, it should be collected. This is absurd and we should not be enacting laws which cannot be complied with and will never be enforced.

Double Taxation Treaties

Draft Schedule A1(7) specifically provides that no protection is to be obtained from a double taxation treaty which might otherwise exclude the individual from charge unless the other country has a tax of a similar character to IHT and the individual actually has to pay some of the tax in the other country (unless he is eligible for a relief or exemption there).

TAAR

It is necessary to consider the specific targeted anti-avoidance rule within the legislation. This is found in schedule A1(6) which provides as follows:

> *"In determining whether or to what extent property situated outside the UK is excluded property, no regard is to be had to any arrangements the purpose or one of the main purposes of which is to secure a tax advantage by avoiding or minimising the effect of paragraph 1 or 5".*

For this purpose a tax advantage has the same meaning as in section 208 FA 2013 – that is to say any kind of relief from or reduction in tax.

The TAAR refers specifically to avoiding or minimising the effect of paragraph 1 or 5 – so anything which improves the taxpayers tax position without regard to paragraph 1 or 5 will be outside the scope of the TAAR.

This is troublesome because for example if a non domiciled individual arranges to purchase a UK residential property with bank debt (even though he could well afford it from his own resources) thereby avoiding or minimises his exposure to IHT on the shares – would that be caught be the TAAR? If not, why not?

Even if the legislation gets you out of the TAAR, that may still not be enough because of the GAAR. The first opinion of the GAAR Panel was published in July 2017 in which they specifically confirmed that:

> *"Merely because legislation deals with particular positions…does not mean that choosing a course of action to utilize that legislation is necessarily either a course of action that is not abnormal or a course of action that is not contrived."*

Professor Willoughby must surely be turning in his grave.