Too hot to handle

Is it time to drop the idea of holding UK property through offshore companies? **PETER RAYNEY** looks at the new rules.

For many years, non-UK domiciliaries have tended to hold their UK properties through overseas-registered companies. This relatively simple form of structuring enables them to take the UK property outside of the clutches of inheritance tax (IHT) because the ownership of the non-UK situs shares becomes excluded property.

Corporate ownership of investment property also remains attractive since any net rental income can be retained at low tax rates within the company whereas it would suffer from relatively high rates of income tax if held directly.

However, the new penal 15% stamp duty land tax (SDLT) rate on "high-value" residential properties together with the annual residential property tax (ARPT) and extended non-resident company capital gains tax charges now impose a potentially heavy burden on residential properties acquired and held in that way. The aim of these punitive charges is to discourage the purchase and holding of expensive residential properties through corporate structures – a practice often referred to as "enveloping". The government clearly dislikes the potential SDLT avoidance opportunities that can be created by enveloping structures, since they facilitate the sale of the shares (instead of the property) at a modest 0.5% stamp duty charge. Moreover, if the company is registered overseas, UK stamp duty can be avoided altogether if the shares are transferred outside the UK.

These new pernicious charges apply only to individual residential properties costing (or worth) more than £2m. The purchase/ownership by companies of less expensive residential property or any commercial property remains the same. Similarly, the purchase of high-value residential properties by individuals and trustees is not affected by these rules, although

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(since 22 March 2012) a 7% SDLT charge arises where they purchase residential properties for more than £2m.

This article takes a closer look at the 15% SDLT charge on corporate acquisitions of residential dwellings costing more than £2m each. I will also briefly review the "complementary" ARPT charge and the extended capital gains tax charge for non-resident companies, which will be introduced in April 2013.

KEY POINTS

- Measures to combat the "enveloping" of UK properties.
- An increased SDLT charge on higher threshold interests.
- The definition of a "dwelling" and the exemption for property developers.
- Be aware that the business exemptions have yet to take effect.
- The importance of accurate reporting for the new annual residential property tax.

The 15% SDLT charge

A 15% SDLT charge is imposed by FA 2003, s 55A and Sch 4A (as inserted by FA 2012, s 214 and Sch 35) and broadly applies to acquisitions after 20 March 2012.

Where an interest in a single dwelling is acquired for a chargeable consideration exceeding £2m, this strictly represents a "higher threshold interest" (HTI) (Sch 4A, para 1). Where the main subject matter of a transaction consists entirely of higher threshold interests, this is referred to as a "high-value residential transaction" and, where this is made by any of the entities listed below, it is liable to a 15% SDLT charge (as opposed to the standard 7% rate for residential property transactions falling in the £2m-plus bracket).

Each dwelling is valued independently to determine whether it exceeds the £2m threshold. If the transaction includes one or more HTIs and other properties, it will be treated as two separate chargeable transactions. The legislation provides that the total consideration given in the single bargain (referred to as the "primary transaction") must be apportioned between the two elements on a just and reasonable basis (see Sch 4A, para 2(3), (4) and para 9). The company would need to complete two separate SDLT returns for the HTI(s) and the other properties respectively (Sch 4A, para 2(7)). In such cases, the 15% SDLT charge would apply to the HTI(s) and the relevant SDLT rate would apply to the remaining property or properties (see ***Bradley Ltd*** below). The properties worth less than £2m each

BRADLEY LTD

In June 2012, Bradley Ltd (a UK company) paid £3.5m for a luxury residential property in Kensington. The property consisted of two self-contained flats with flat 1 and flat 2 valued at £2.5m and £1m respectively.

Since the properties are acquired through a company, the total SDLT charge is £415,000, calculated as follows:

Property	*Cost/MV*	*SDLT rate*	*SDLT charge*
Flat 1	£2.5m	15%	£375,000
Flat 2	£1m	4%	£40,000
Total SDLT			£415,000

are not linked to the acquisition of the HTI for the purposes of determining the relevant SDLT rate.

However, the linked transactions SDLT rule in FA 2003, s 108 does not apply for HTI charging purposes. Thus, for example, the 15% charge would not apply where several residential properties (each worth less than £2m) are purchased from the same seller for a total amount of (say) £3.5m.

On the other hand, there is an anti-fragmentation rule that amalgamates various legal interests acquired in a single dwelling (Sch 4A, para 4).

Acquisition by companies etc

The 15% higher-rate SDLT charge applies only where the acquisition of a higher threshold interest (HTI) is made by one of the following:

- A company (UK or non-UK).
- A partnership which has one or more corporate partners.
- A collective investment scheme (including a unit trust) (Sch 4A, para 3(3)).

There are exclusions for companies acting in their capacity as trustees for a settlement and property developers that meet certain conditions (see below).

Partnerships that include a corporate partner (which is not unusual) must be particularly vigilant since they are within the scope of the higher SDLT rate charge. A further trap may occur where a partnership of individuals is set up to acquire high-value residential property, since this may be caught as a collective investment scheme if they do not have day-to-day control over the management of the property.

If an HTI is acquired jointly by two or more purchasers, and at least one of those purchasers is one of the entities described above, the 15% charge will apply to the entire transaction.

Higher-rate charge on dwellings

To be caught by the higher-rate SDLT charge, the relevant property must be a "dwelling". Sch 4A, para 7 provides that a building is regarded as a dwelling if "it is used or suitable for use as a single dwelling, or it is in the process of being constructed or adapted for such use", including any land enjoyed with the dwelling etc.

HMRC take the view that use at the transaction date overrides any past or intended future use for this purpose (see HMRC'S *Stamp Duty Land Tax Manual* at SDLTM20076). If a building is not in use at that point, but was last occupied as a dwelling, it will be taken to be "suitable for use as a dwelling" unless persuasive evidence is produced to the contrary.

Undeveloped land would generally be non-residential, but could be residential property at the date of the transaction if a residential building is being built on it.

A property with a long history of non-residential use and which does not have permission to be occupied as a residence is unlikely to be viewed by HMRC as a dwelling or suitable for use as a dwelling.

The deemed dwelling rules in FA 2003, s 116(2), (3) do not apply for the purposes of the 15% SDLT rate provisions and hence the rate will not apply to accommodation for school pupils or the armed forces. Similarly, halls of residence for students, residential care homes, or hotels etc are exempt from the higher SDLT charge (Sch 4A, para 7).

> ***"There is an anti-fragmentation rule that amalgamates various legal interests acquired in a single dwelling."***

Under the normal SDLT provisions, the purchase of at least six separate dwellings at the same time is treated as the acquisition of non-residential property and may attract a lower SDLT rate (s 116(7)). However, this rule does not apply for the purposes of the 15% HTI charge and, hence, where such a multiple purchase transaction includes an HTI it will always be treated as a residential one.

Property developer exemption

An important exemption is given to genuine property development activities carried on through companies, although this is currently circumscribed by a number of stringent conditions.

A property development company (or partnership) will not be subject to the 15% SDLT charge where:

- the residential property is acquired for the sole purpose of developing and reselling the land; and
- the company (or partnership) has carried on its property development business for at least two years (Sch 4A, para 5).

For these purposes, a property development business is one that includes the buying and developing of residential property for resale. HMRC consider that this covers a wide range of activities, including the substantial refurbishment of an entire property (eg fitting new bathrooms, kitchens etc) before resale, performing extensive works on the property, or the demolition

of the property and replacement with one or more new residential units or a commercial property. On the other hand, an intention to carry out only minor redecoration before an onward sale would not be regarded as property development (see HMRC's *Stamp Taxes Bulletin 2/2012*).

Given that most substantive property developments are structured through new companies, there is a helpful deeming rule in Sch 4A, para 5(6). This provides that a company can meet the two-year history of property development business requirement where a fellow 75% group company has carried on a property development trade over the previous two years (see ***Ennis Developments Group Ltd*** below).

> ***"Unfortunately, the extended business-related exemptions will not take effect until the Finance Bill 2013 receives royal assent."***

The requirement to be carrying on a property development for the past two years has been criticised as being unnecessarily restrictive. Thus, where a singleton company (which has traded for only (say) 15 months) acquires a dwelling for (say) £3m for redevelopment, it is not protected by the property developer exemption.

Additional business exemptions

The good news is that the Finance Bill 2013 contains a much wider business exemption to include dwellings (HTIs) that are acquired exclusively for the following business purposes:

- rental investment;
- redevelopment and sale in a property development trade (ie one that includes the buying and redeveloping for resale of residential/commercial property on a commercial basis);
- resale in a property dealing business;
- enjoyment by the public on a commercial basis for at least 28 days a year (eg stately homes and mansions);
- employee accommodation (provided employees have less than a 5% equity stake in the business or company);
- as a farmhouse that is occupied by farmworkers for the purposes of a commercially run farming trade; or
- charity.

ENNIS DEVELOPMENTS GROUP

The Ennis Developments Group Ltd has been trading for more than 10 years as a property development group specialising in the redevelopment and renovation of old residential buildings. In June 2012, it set up a 100% subsidiary company, Kensington Construction Ltd, to undertake a massive redevelopment of three run-down Georgian houses in Kensington. As part of this project, Kensington Construction Ltd paid £15m to acquire the freehold interests in three blocks of flats (each worth more than £2m).

Because Kensington Construction Ltd can be treated as carrying on a property development trade for at least two years (by virtue of the group's property development activities in the past two years), it can benefit from the property developer exemption.

Thus, its SDLT liability on the purchase is based on the relevant residential 7% rate – ie £15m x 7% = £1,050,000 (as opposed to £2,250,000 being the charge at the 15% rate).

ARPT RATES

Taxable value at relevant day	*Annual chargeable amount**
Up to £2,000,000	No charge
£2,000,001 to £5,000,000	£15,000
£5,000,001 to £10,000,000	£35,000
£10,000,001 to £20,000,000	£70,000
Over £20,000,000	£140,000

* Increased annually by reference to the consumer prices index.

The property rental investment, development and dealing exemptions are all subject to the property not being occupied by a non-qualifying individual (even on a commercial basis). Such an individual is widely defined and includes someone who owns a company, their spouse and relatives, spouses of those relatives etc.

The above business exemptions, which must be claimed, are all subject to withdrawal if certain conditions are not satisfied throughout the three years following the acquisition of the property (to ensure that the basis for the relief is reasonably permanent).

Unfortunately, the business-related exemptions will not take effect until the Finance Bill 2013 receives royal assent – probably in June or July 2013. So, until then, property-related businesses can rely only on the rather limited "property developer" exemption in Sch 4A, para 5.

The ARPT charge

The annual residential property tax (ARPT) will commence on 1 April 2013. This is part of the government's new fiscal weaponry to prevent the enveloping of high-value residential property through company structures, while ensuring the owners of such property pay their fair share of tax. One of the main concerns is that the ARPT represents a "dry" tax charge and some of the property owners may not have the cash to pay it.

The Finance Bill 2013 provides that the ARPT is levied in respect of a chargeable interest if, on one or more days in the chargeable period (being the 12 months to 31 March each year):

- that interest is a single dwelling interest (broadly, an exclusive interest in or over land that consists of a single dwelling) which has a taxable value of more than £2m; and

- broadly, either a UK/overseas company, corporate partner of a partnership, or a collective investment scheme is beneficially entitled to that interest. (Thus, properties held bycompanies in a nominee capacity (eg for confidentiality) are not caught.)

It is now clear that ownership by trusts, partnerships or limited liability partnerships will not be subject to the ARPT charge.

It will also be appreciated that, while slightly different terminology is used, the scope of the ARPT is the same as that of the higher 15% SDLT rate. It will therefore typically apply to dwellings held by companies that are worth more than £2m.

Thus, the definition of "dwelling" is similar to that used for the purposes of the higher-rate SDLT charging provisions and includes any land that is occupied or enjoyed with that dwelling.

Calculating the ARPT

Where a company (or other chargeable entity) holds the single dwelling interest on 1 April 2013, the ARPT is based on its taxable value at that date (which, in turn, is based on its actual value on 1 April 2012). This taxable value will form the basis of the ARPT charge for the next five years, with the next base valuation being made on 1 April 2017. Practitioners should note that property valuations are self-assessed, although it is recommended that professional valuations should be obtained to avoid incurring any HMRC penalties for unreasonable under-valuations.

For single dwelling interests acquired after 1 April 2013, the taxable value will (broadly) be its value at the date of acquisition (subject to five-yearly revisions).

The charges for 2013/14 are as shown in ***ARPT Rates***.

A reduction in the ARPT charge can be claimed if the dwelling is not held throughout the chargeable period (ie the 12 months to 31 March). In such cases, the charge is calculated daily by reference to the number of days the property was held.

The ARPT return and payment of the relevant tax is normally due on 15 April in the relevant chargeable period. However, as a transitional measure for the first year, the first ARPT return for the period 1 April 2013 to 31 March 2014 is due for filing by 1 October 2013 and payment is due by 31 October 2013.

The ARPT legislation provides similar business exemptions to those available in the Finance Bill 2013 for relief from the 15% SDLT charge (see above). Thus, dwellings used in property rental businesses, property development trades and properties open to the public etc are exempt from this charge. However, due to the daily basis of calculating the ARPT charge, these exemptions must be claimed on a daily basis, with the total relief being based on the number of days the relevant business exemption conditions are satisfied. Clearly, if the relevant conditions are satisfied throughout the chargeable period there is no ARPT charge.

Non-resident companies

The planned extension of capital gains tax to (broadly) UK residential properties held by *non-resident* companies has been watered down considerably. Although a 28% capital gains tax charge will arise on property disposals that take place on or after 6 April 2013, this now only applies to individual properties sold for more than £2m.

Although we await the final detailed proposals, any capital gains will be subject to rebasing, so that only the gain accruing after 6 April 2013 will be taxed. Furthermore, most disposals should be protected by one of the business exemptions (detailed above for the 15% SDLT charge).

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Such gains can, of course, still be fully taxed under the panoply of existing capital gains tax anti-avoidance rules (although it is expected that they will now exclude gains caught under the extended company capital gains tax charge).

Pause for thought

In conclusion, the scope of the new 15% SDLT charge, the ARPT, and the extended capital gains tax charge are not as bad as originally feared. Significantly, properties held directly by trusts will not be subject to any of these tax charges. Although trusts will be subject to income tax and inheritance tax, they still offer considerable advantages in terms of asset protection and anonymity. Limited liability partnership structures are also still likely to appeal to some property investors and developers.

Nothing has really changed for non-domiciliaries holding less expensive UK property – it is business as usual for them. However, those non-domiciliaries holding UK residential property worth more than £2m through envelope structures should review their arrangements even if they then decide to do nothing.

Some may consider the ARPT charge to be palatable, particularly if their property falls at the higher end of a charging band – for example, a property worth (say) £4.5m would suffer an ARPT in 2013/14 of only £15,000 – an effective tax rate of 0.33% per year. Others may wish to avoid the ARPT and therefore seek to unwind their envelope structures to bring the property back into their personal ownership. This will depend on the tax costs of extracting the property from the structure. Such action would increase their inheritance tax exposure, but this could be mitigated by, for example, borrowing against the relevant UK property or by insurance to fund it. ■

Peter Rayney CTA (Fellow) FCA TEP is an independent tax consultant and the author of *Tax Planning For Family and Owner Managed Companies – 2012/13*. He can be contacted by email at peter@prtaxconsulting.co.uk or visit www.peterrayney.co.uk.