GOVERNMENT CONSULTATION ON TAXATION OF RESIDENTIAL PROPERTY – PROPOSED CGT, ANNUAL CHARGE AND SDLT MEASURES

The Government has recently published its Consultation Paper in relation to the extension of Capital Gains Tax and Stamp Duty Land Tax on residential properties. The changes are proposed in order "to ensure that individuals and companies pay a fair share of tax on residential property transactions and to tackle avoidance, including the wrapping of property in corporate and other "envelopes". The Paper states that the Government is concerned at the prevalence of "enveloping" of high value residential properties (for example, by owning them through companies) and expressly acknowledges that part of the aim is to encourage people holding UK residential property through companies to unwind those structures.

In outline, the new structure is as follows:

1. with effect from 21 March 2012 a new 15% rate of SDLT applies on purchases of UK residential properties worth over £2 million and owned by non-natural persons (ie. companies, collective investment schemes or partnerships which include a corporate partner);

2. from 1 April 2013 an annual charge will apply in relation to UK residential properties valued at over £2 million and owned by non-natural persons (ie. companies, collective investment schemes or partnerships which include a corporate partner); and

3. from 6 April 2013 the Capital Gains Tax regime will be extended to tax gains on the disposal of UK residential property, and shares or interests in such property, by nonnatural persons (ie. companies, trusts or personal representatives – note that trusts and personal representatives are included in the definition for CGT purposes but not in the definition for the purposes of the annual charge above) who are non-UK resident.

As the first point above has already come into effect, the Consultation Paper focuses on the second and third points. The Consultation is open for 12 weeks. A response will be published by the Government in the Autumn, alongside draft legislation (to be implemented through the Finance Act 2013).

In summary, the proposed changes will apply so that residential properties valued at over £2 million and owned by a company will be charged annually to tax and, if owned by an offshore company, will also be charged to CGT when they are sold. While much recent commentary has focused on the implications for offshore trusts and companies, the changes affect UK property-owning structures as well – directors and/or trustees of both onshore and offshore structures should now be considering what steps to take in order to minimise their tax exposure.

ANNUAL CHARGE PROPOSALS

The issue which the annual charge proposals aim to alleviate is that currently, if a residential property is owned by a company, SDLT can potentially be avoided on a sale. This is because the ownership of the company can be transferred through a share transaction, rather than ownership of the property being transferred by a sale of the property itself, meaning that the transfer is not liable to SDLT as the property itself has not changed ownership (although 0.5% stamp duty is payable in respect of a transfer of UK company shares).

The idea is that the proposed annual charge will address this by ensuring that tax is levied on an annual basis on UK residential properties valued at over £2 million and owned by a company.

The proposed annual charges will be:

1. £15,000 on properties valued between £2 million and £5 million;
2. £35,000 on properties valued between £5 million and £10 million;
3. £70,000 on properties valued between £10 million and £20 million; and
4. £140,000 on properties valued over £20 million.

Properties will have to be valued every 5 years by those liable to the charge. It is likely, therefore, that the property owners will need to commission a professional valuation report every 5 years.

The annual charge is designed not to apply to a *bona fide* property development business with a 2 year track record nor to a professional trustee who holds the property directly (as opposed to through a company).

CGT PROPOSALS

The issue which the CGT proposals aim to alleviate is that currently, CGT is generally only payable by UK residents, meaning that gains on disposals of UK residential properties by non-resident companies or trusts are not typically subject to CGT (although if a UK resident beneficiary owns UK property through an offshore company or lives in a UK property held by an offshore trust, charges can arise under existing anti-avoidance rules).

The proposed extended regime will ensure that, where non-resident companies or trusts dispose of a UK residential property for more than £2 million, CGT will be charged on any gains realised. This means that where CGT is charged in respect of a UK property, the company or trustees will now, for the first time, be directly liable for tax levied. There will not be a carve-out for professional trustees who hold the property directly, as there is to be with the annual charge (see above).

The rates of CGT to be applied to properties will not be published until the next Budget.

On a disposal of a property after implementation of the new charge in April 2013, CGT will be payable in respect of the total gain accrued during the period of ownership, not only in respect of the gain accrued since the rule change.

It should be noted that, while Principal Private Residence Relief (PPR) would be available on a sale of a “main” UK residence which is owned personally by a UK resident or owned by an offshore trust whose beneficiary occupies the property as his/her main residence under the terms of the trust, PPR will not relieve any gain on a individual’s ‘main’ residence where that residence is owned by an offshore company.

While the Consultation Paper mentions the interaction between existing CGT provisions and the new legislation, it does not conclusively say how potential multiple charges would be dealt with – it merely says that they will ensure a sensible prioritisation of charging provisions. We would hope that where the proposed new CGT charge takes priority, any existing charge where the company/trust structure is offshore under “section 13” (which applies so that gains of a close company are attributed to their owners) or “section 87” (which applies so that beneficiaries are charged to tax on a trust’s gains to the extent that they receive a capital benefit from the trust) would be necessarily offset/overridden, however this is not yet clear.

WHAT CLIENTS SHOULD DO NOW IF THEY OWN A HIGH VALUE UK PROPERTY THROUGH A COMPANY

Weighing up the pros and cons provided by the company

Each client who owns a UK property through a company should have their structure reviewed to see if it should continue to run or whether it would be more advisable to have it wound up before the law changes next April.

An advantage of a non-domiciled (and non-deemed domiciled) client holding property through an offshore company is that the value of the property is protected from inheritance tax on the client's death. If the property is owned personally, in contrast, it will be exposed to 40% IHT on the client's death. The protection of a high-value property from IHT is a significant advantage and should be carefully considered before any property-owning offshore companies are wound up and the IHT advantage is lost.

The facts of each case will clearly need reviewing here to balance the IHT advantage against the proposed annual charges and the CGT payable on a sale. For example, if a non-domiciled client sees themselves residing in their UK property for the medium term but then plans to sell the property and leave the UK, the protection from IHT which the company provides may not be as important as qualifying for CGT relief.

The IHT advantage will need to be weighed against the benefit of unwinding the company and transferring the property into the client's own name - this would remove the application of the annual charges and, of course, the costs of running the company.

Moreover, if the client occupies the property as his/her main residence, removing the company from the equation would mean they could potentially benefit from 100% Principal Private Residence relief from CGT on a sale. If an individual client is non-resident when they sell a property which they own directly, CGT will then not then come into play at all.

It should be noted that if a client chooses to unwind their company, there may still be routes to consider reducing their IHT liability on the property by other means, such as securing debt on the property.

If it is decided to keep the corporate structure in place, the client should still be mindful of other issues relating to the property, such as the risk of a “benefit in kind” charge should they occupy the property.

Considering the potential pitfalls of winding up the company

If it is found that the cons of the company structure will outweigh the pros once the new rules apply, care will need to be taken in looking at the tax implications of winding up the company under the current legislation.

The advice given in reviewing each client’s situation and deciding on the best course of action here will vary depending on whether they are UK resident or non-resident. Non-UK resident clients can consider winding up a company holding a high value UK property before the rules change without falling foul of a CGT charge under the current rules (although they will have to be mindful of any relevant taxes in their jurisdiction of residence). However, once the rules change this option may be prohibitively costly from a tax point of view.

However, for UK resident clients there is a risk of triggering a CGT liability under the legislation currently in place. Where the property is held in an offshore trust and is occupied rent free by a UK resident beneficiary, that beneficiary will have been receiving a capital benefit from the trust and so may be exposed to a CGT liability when the structure is wound up. Further, if the trustees hold the property through an offshore company, the PPR exemption from CGT will not apply.

In conclusion, each case will need to be carefully considered to ensure the client is not walking into a tax pitfall, whether by leaving the company running or, in fact, winding it up without proper advice. Where it is found best to unwind a structure at this stage, there are many different options available as to how this is done, and one route may not have the same tax implications as another.

Directors/trustees of both onshore and offshore companies/trusts should be alive to the options that face them long before the changes are implemented next April – once the law has changed the window of opportunity to wind up a structure tax efficiently may have passed.

It will be necessary to calculate and weigh the tax cost of continuing to run the company into the new regime against the tax cost of winding the company up now. Therefore, work in looking at any structure affected should not be left until the end of the tax year, when thorough examination may not be possible – work should begin well in advance to ensure the best solution can be found.

If you would like to talk to someone about the issues raised above, please contact:

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Please note that the information in this note is necessarily brief and is not intended to be an exhaustive statement of the law or relied upon as legal advice. It is essential that professional advice is sought before any decision is taken.

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