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Residential Property *Tax update*

JANUARY 2017

TIMELINE OF TAX CHANGES
REFORMS IN DETAIL
PROPERTY CONSIDERATIONS



A changing **property tax environment**

Residential property has been subject to wide-ranging tax reform over recent years. The new Chancellor, Philip Hammond, gave some respite at the end of last year, when his first Autumn Statement was absent of significant new reforms. Despite this welcome development, recent changes and future promised reforms were all left in place with implications for property owners and investors.

The cumulative impact of recent tax changes has been to make transacting on prime (£1m+) property more expensive and has unsurprisingly led to a slowdown in sales activity. In central London a rising tax burden has also contributed to price falls in the past 18-months, although growing political uncertainty, following the outcome of the EU Referendum and the run-up to Brexit, has also helped to create more sober market conditions.

We shouldn't overdo the gloom though. There is growing evidence that price falls have helped to create new activity in the market. While transaction volumes in central London fell by around 35% year-on-year in the period immediately after the EU Referendum, by the final quarter of 2016 sales bounced back. In fact our experience was that the last three months of 2016 saw more transactions in central London than the same period of 2015. Lower pricing and a weaker pound appear to have galvanised UK and international buyers into taking action.

Despite this recent upturn there is no doubt that taxation has become a more significant issue. It adds a new dimension to investment planning and portfolio management and requires investors to think through all their costs in detail, and also the performance of their properties, to help raise investment returns.

In this short update we have pulled together a summary of the main changes in property taxation and have assembled a range of experts from Knight Frank to give their views on how you might want to consider your position in the run-up to the start of the new tax year.

BDO's Private Client Tax Team have kindly provided their insight over the next two pages to help you navigate this complex changing environment.

If you have questions about changes to property taxes and policies and how they could affect you and your property assets please contact one of our experts listed on the final page of this document.

“TAXATION HAS BECOME MORE SIGNIFICANT FOR INVESTMENT PLANNING AND PORTFOLIO MANAGEMENT”

Liam Bailey
Head of Global Research

The research team at Knight Frank produce a range of regular market updates covering: London, country, rural and investment property, both commercial and residential. All are designed to give you the most current insight into market trends to help you stay informed and to give you the intelligence you need to make informed decisions. Our research can be found at www.knightfrank.com/research.

Timeline of tax changes

BDO Private Client Tax Team



The last few years have seen a transformation in the landscape for the taxation of property ownership in the UK with further changes taking place in (or being phased in from) April 2017.

Most owners of property, whether the property is held as trading stock or for investment, whether individuals or corporates or whether UK resident or non-UK resident will be affected by at least some of the changes. Professional advice should be sought to fully understand the implications of the new rules and how these may impact you currently and in the future.

The table below gives a summary of the key changes over the period since April 2015 and those which are anticipated up to 2020.

Inheritance Tax (IHT)

New rules are also being brought in from April 2017 to charge IHT on UK residential property held in offshore structures. This is a major change for non-domiciliaries, making it more difficult to manage IHT exposure on UK residential property. In the past, a non-domiciled individual wishing to acquire UK property would typically hold the property via a non-resident company which in turn was held by a trust. The trust's asset was the shares of the non-resident company. This was 'excluded property' and effectively 'exported' the UK property so that it was sheltered from IHT.

From 6 April 2017, the definition of 'excluded property' will change so that the shares of

an offshore company will not be 'excluded' to the extent that the company derives its value from UK residential property, and therefore the shares will be liable to UK IHT. Similar rules will apply where UK residential property is owned via offshore partnerships or other vehicles. The new rules will apply to all chargeable events (e.g. a death or a trust 10 year anniversary) after 5 April 2017.

There will be no exemption for commercially let properties and no incentive to encourage the removal of UK properties from offshore structures.

New rules also mean that loans used to acquire UK residential property, or assets used as security or guarantees for such loans, may also be treated as UK assets which are liable to IHT for the lender.

Loans and interest risk

A number of key tax considerations arise from financing the acquisition of UK property through loans. In particular, the tax deductibility of the interest and whether or not any tax might need to be withheld on payment of the interest.

Where interest is paid between connected parties, for example from a subsidiary company to a parent company, it is necessary to consider whether the amount of interest payable on the loan would be payable were the loan to be made between independent third parties bargaining at arm's length. In the first instance, a restriction in the deduction for interest may arise where the amount paid exceeds what would arise at arm's length.

In particular circumstances, where the interest is paid cross-border or to an individual, there

may be an obligation to deduct UK withholding tax at 20%.

Where the taxpayer is an individual within the charge to income tax, the basis for tax relief is being reformed from April 2017 so that instead of interest on loans being a tax deductible expense, it will instead give rise to a tax credit at the basic rate of tax. This will be phased in over four years, with the proportion of interest being treated as giving rise to a tax credit increasing by 25% each year. This will give rise to a significant additional tax burden for higher-rate taxpayers.

Companies chargeable to corporation tax also face a restriction in the deductibility of interest from April 2017, in many cases to the higher of 30% of EBITDA or £2m. The new regime is complex and still evolving and operates on a group-wide basis. It is likely that companies currently chargeable to income tax will be brought within the charge to corporation tax from April 2018 so that the restriction will also apply to them from that date.

Non-Resident CGT (NRCGT)

Since 5 April 2015, non-resident individuals (including partners with a share of a partnership gain), trustees and personal representatives of a non-resident individual, specifically defined closely-held companies (normally, those held by five or fewer participators), and certain unit trusts, have been liable to pay CGT on gains realised on the disposal of UK residential property.

Broadly, this means UK buildings in use or being constructed or adapted for use as a dwelling, and rights or options to acquire an

interest in such property. Unlike ATED-related CGT, there is no de minimis value, and commercially let property is caught.

CGT is charged on the rise in value between 6 April 2015 and the date of disposal, with indexation for companies, but no ATED-type reliefs. The vendor can elect to calculate the gain by straight-line apportionment since the purchase date, or for the entire gain since the purchase date to be taxed.

Private residence relief is available in limited circumstances.

The filing obligations are strict: a NRCGT return must be filed for each disposal of a UK residential property, 30 days after conveyance of the property, even if the disposal is chargeable to ATED-related CGT or does not result in a NRCGT gain. Any tax due is payable 30 days after conveyance, unless the vendor files self-assessment returns, in which case tax can be paid on the normal self-assessment due date.

Further complexity appears when property is held within a non-UK resident trust as gains on disposal may be taxed in more than one way. The order of precedence for CGT on a gain on disposal of a UK residential property by a non-resident is:

1. ATED-related CGT
2. NRCGT
3. CGT under pre-2013 anti-avoidance legislation such as that which attributes gains to UK resident settlors and/or beneficiaries.

Revaluation of gains

As shown above, UK properties may need to be valued at 5 April 2015 to calculate the NRCGT. Further valuations may be needed at 6 April 2017 for non-UK properties and other assets owned by non-domiciliaries who are long-term residents of the UK.

If a non-domiciled individual has already been resident in the UK in at least 15 tax years on

6 April 2017, he will be deemed UK-domiciled from that date for all taxes. Capital gains made on the disposal of offshore assets will then be liable to CGT. However, in some cases the pre-6 April 2017 proportion of the gain will not be taxable.

To achieve this, assets held personally outside the UK will be revalued for CGT purposes as if they were acquired on 6 April 2017, effectively exempting earlier gains. Assets held within overseas structures such as trusts or companies will not benefit from rebasing.

Annual Tax on Enveloped Dwellings (ATED)

Since April 2013, the 'annual tax on enveloped dwellings' has applied an annual tax charge on 'enveloped' UK residential properties held by non-natural persons, typically via a non-resident company (although a corporate partner in a partnership or LLP, or a collective investment vehicle such as a unit trust is also caught). ATED does not apply to properties held directly by individuals or trustees, or which are commercially let. There are other reliefs for employee – or partner – occupied properties, social housing, farmhouses, and dwellings open to the public.

Originally ATED applied only to properties valued at £2m or more on 1 April 2012. Property valuations for this purpose are due to be rebased on 1 April 2017. The threshold was reduced to £1m from April 2015 and to £500,000 from April 2016. The annual tax charge is £3,500 for a property worth between £500,000 and £1m, rising to £218,200 for a property valued at over £20m.

ATED-related CGT applies on disposal of a property subject to ATED where the disposal proceeds exceed £2m for disposals from 1 April 2013; £1m for disposals from 1 April 2015, and £500,000 for disposals from 1 April 2016. Disposals of properties by non-residents valued at less than those limits will be subject to NRCGT (see below).

ATED-related CGT is charged on the rise in value from 1 April 2013 (or later acquisition date) to disposal, subject to time-apportionment for periods where ATED is either not chargeable, or a relief is available. Alternatively the charge may be based on the full gain, with relief for days when ATED does not apply. A tapering relief may be given where a property is disposed of for a consideration marginally over the chargeable level.

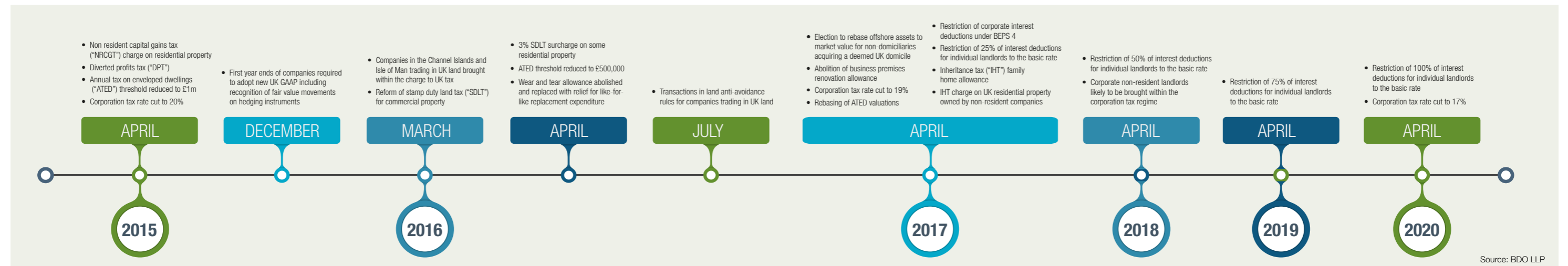
There is no indexation allowance for ATED-related CGT. An ATED-related CGT return must be filed and tax paid by the usual self-assessment filing deadline.

Stamp Duty Land Tax (SDLT)

There have been two fundamental reforms to SDLT:

Firstly, the charge on commercial property has been reformed since 17 March 2016 such that tax is now charged on the amount of the purchase price falling within each rate band rather than at the rate for the band in which the total consideration falls. Although the tax rates are different, this reform has aligned the system for taxing purchases of commercial property with that which has existed for residential property for some time. However, the adjustment of the rate bands to give effect to the reform has resulted in additional SDLT charges for acquisitions of commercial property at values above £1.05m.

Secondly, from April 2016 a premium of 3% applies to the SDLT rates chargeable on the acquisition of residential dwellings. In the case of companies, this applies to all such purchases. In the case of individuals, subject to certain exceptions, it applies only to the acquisition of a second (or subsequent) dwelling where more than one dwelling is owned at the end of the day of acquisition.



Source: BDO LLP

Property Focus

James Thompson, Head of London Valuations and Consultancy

What are clients talking to you about right now in terms of their valuation requirements?

Currently our clients are looking into the implications of recent legislation, to include the loss of Inheritance Tax protection for enveloped properties from April 2017 whether commercially let or not. They are considering the decisions that need to be made prior to the ATED rebase valuation set for April 2017. There also remains some confusion as to when the revaluations need to be undertaken as it appears that while the valuation date is 1 April 2017, the figure will not be submitted until next year. Some clients are currently considering de-enveloping and in some cases selling. We are currently undertaking a variety of valuations for properties in structures at different points in time – mainly 2013 and 2015 – to establish potential ATED CGT and NRCGT liabilities on any transfers.

How are Knight Frank working with clients and advisers to prepare them for April?

Tax valuation is at the heart of what we do and can form the majority of the work undertaken by the Knight Frank residential valuation team. We are able to adopt a pragmatic solution to suit clients' needs along with our extensive experience of negotiations with the HMRC when required. Reports can be tailored to suit preference and we have implemented systems to provide an efficient and streamlined method of reporting in a timely fashion. We are strongly recommending clients consider their positions backed up by professional advice sooner rather than later in order to understand their position and options available to them.

Tom Barrow, Head of Country Valuations

What are your clients' key tax valuation requirements at the current time?

As a team we are very busy with the usual range of tax planning requirements. Inter-generational transfers of wealth, CGT and IHT planning are critical requirements as always. Clients have started to prepare for ATED related valuations for the forthcoming 1 April 2017 valuation date. The volume of this work is set to rise strongly now the threshold has fallen to £500,000.

Are there any special issues investors need to be mindful of when arranging valuations of country property for, say, CGT?

There are several specific areas for owners to consider, especially related to the use of land and buildings and how value is apportioned between permitted area (free of CGT) and non-permitted area (subject to CGT). These issues have become more critical to understand as HM Revenue & Customs takes a more forensic approach on the sale of property in excess of 1.23 acres.

Simon Gammon, Head of Knight Frank Finance

Are your clients thinking about debt in their tax planning?

If the advice for a client recommends that any property holdings need to come out of the current ownership structure and into personal names, and/or the property is being gifted to family members in the process, any debt secured against the property will need to be reviewed as well. It is possible the current lender may not be able to accommodate the new arrangement or that there are better rates out there in the market.

Is life insurance an interesting option for IHT planning?

For some situations an effective solution to cover the new IHT liability could be through an insurance policy. Thereby rather than avoiding the tax charge, clients can plan for it in an efficient way. Whether it is a short or long-term liability will depend on the client's situation and actions taken, but we can provide policies for both requirements.

Freddie Hills, Head of Customer Care

What steps can investors take to review their portfolios?

The first step we take with investors is to consider the portfolio as a whole. Our initial discussion is designed to review the current portfolio with a view to identifying the properties which are generating the best returns and those for which there may be room for improvement.

Our knowledge of local markets allows us to consider current and potential rental returns throughout London and the UK, meaning we can guide investors through the range of options available, from selling current stock and buying in new growth areas to re-financing or releasing equity.

How can furnishing and property management help maximise post-tax returns?

While tax rules around allowable expenses have changed recently, there is still the potential to offset any new furniture purchases against your rental income, helping to reduce your liability.

Our primary focus with lettings and property management is to maximise your rental return whilst minimising void periods. It is easy for agents to sway investors with the prospect of low fees but we never forget that it is the landlord's net rent after such fees that drives return.

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