# DE-ENVELOPING UK RESIDENTIAL PROPERTY

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**What is Enveloping?**

1. In its introduction to the Annual Tax on Enveloped Dwellings, the government described enveloping as follows:

> *"2.3 Enveloping of a property occurs when that property is acquired using a "non-natural" person. For example, an individual may set up a company which then purchases a property to hold as the sole asset of the company. The property is then said to be "enveloped" into the company. In the context of the annual charge, a non-natural person is defined as companies and other bodies corporate, collective investment vehicles and partnerships including one or more such entities.*

2. It was clear that in 2012, the government considered that the stamp duty land tax ("SDLT") advantages were the primary driver behind enveloping properties:

> *"2.4 The Government's concern with regard to enveloping centres on the example set out above whereby an individual establishes a company to envelope a property owned for the personal use of that individual or their family. It is then possible to transfer the ownership of the company (and thereby the economic ownership of the property) without paying SDLT by selling the shares in the company."*

3. In September 2015, HMRC commissioned the IFF to look into why people actually enveloped their properties. The IFF research in "Views and behaviours in relation to the Annual Tax on Enveloped Dwellings"

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showed that the main reason as to why residential properties were enveloped without commercial purpose were (at page 12):

*"5.3 Respondents reported that properties were largely enveloped for two reasons, one directly related to tax (IHT planning) and the other was non-tax related (privacy).*

*5.4 In agents' experience, IHT planning was the most common tax reason given for enveloping properties. Holding a property in a corporate envelope in certain circumstances ensured that the value of the property did not contribute to an individual's personal wealth, and therefore a reduced amount of IHT would be payable on their death.*

*[---]*

*5.7 Protection of privacy was commonly cited as a non-tax reason for enveloping by agents, particularly amongst people with very high levels of wealth, high-ranking individuals, or those in the public eye. These owners of envelopes did not want the value and / or the address of their property to be publically known. One way to ensure anonymity was for the property to be held by a company to ensure their own name was not on the land registry."*

## The Inheritance Tax and Stamp Duty Land Tax Advantages

### *Inheritance Tax*

4. Following section 5 Inheritance Tax Act 1984 ("IHTA"), a person's estate is the aggregate of all the property to which he is beneficially entitled but does not include excluded property. Section 6 provides that property situated outside the United Kingdom is excluded property if the person beneficially entitled to it is an individual domiciled outside of the United Kingdom.

5. United Kingdom land will always be situated in the United Kingdom; however, shares situated outside of the United Kingdom in a company which owns a property in the United Kingdom will not be. Therefore, individuals who were non-UK domiciled were placing their UK residential property into off-shore structures in order to take their UK property outside of the inheritance tax ("IHT") net.

*Stamp Duty Land Tax*

6. Where an interest in land is sold SDLT is generally payable on the consideration.

   However, where property is owned through a company, the underlying property can be sold by transferring the shares of the company rather than the property itself. This transaction is not subject to SDLT.

7. Given the high rates of SDLT, this can be a significant saving:

| *Property or lease premium or transfer value* | *SDLT Rate* |
|---|---|
| Up to £125,000 | Zero |
| The next £125,000 (the portion from £125,001 to £250,000) | 2% |
| The next £675,000 (the portion from £250,001 to £925,000) | 5% |
| The next £575,000 (the portion from £925,001 to £1.5 million) | 10% |
| The remaining amount (the portion above £1.5 million) | 12% |

8. The government introduced a 15% SDLT rate for high value residential dwelling purchased by non-natural buyers.

## The Government's Response

9. The Government announced a package of measure in Budget 2012 which were aimed at ensuring 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". It introduced the following three measures:

   *"First, the introduction from 21 March 2012 of a 15 per cent rate of SDLT on acquisitions of residential dwellings costing more than £2 million by certain nonnatural persons (companies, partnerships including a company and collective investment vehicles);*

   *Second, from 1 April 2013, an annual charge on residential property owned by non-natural persons, which is discussed in Chapter 2; and*

   *Third, from 6 April 2013, the extension of Capital Gains Tax (CGT) to gains on the disposal of residential property by non-resident companies and others (but not individuals), which is discussed in Chapter 3."*

*Annual Tax on Enveloped Dwellings*

10. The Government therefore introduced the Annual Tax on Enveloped Dwellings ("ATED"):

*"The Government is concerned at the prevalence of enveloping of high value residential properties and the potential for SDLT avoidance on subsequent changes of ownership of the properties. The annual charge is a new tax being introduced to encourage those who own UK residential properties valued over £2 million in envelopes to take them out of those envelopes. This will ensure that any future transfers of the property will be subject to SDLT, and that a fair share of tax is paid on these properties."*

11. ATED is found in Finance Act 2013. It operates as an annual charge where a non- natural person (a company, partnership or collective investment scheme) meets the ownership condition with respect to a single dwelling interest in the UK. The ownership condition is met on any day on which the company is entitled to the interest.

12. ATED is chargeable each "chargeable period". Originally it was charged only on properties worth more than £2m. However, the rates now apply to residential properties more than £500,000:

| *Property value* | *Annual Charge* |
|---|---|
| More than £500,000 but not more than £1 million | £3,500 |
| More than £1 million but not more than £2 million | £7,000 |
| More than £2 million but not more than £5 million | £23,350 |
| More than £5 million but not more than £10 million | £54,450 |
| More than £10 million but not more than £20 million | £109,050 |
| More than £20 million | £218,200 |

13. There are important reliefs to ATED in section 132(3) FA 2013 which are set out here as in considering whether to de-envelope it is helpful to consider what reliefs to ATED are available:

*"132 Effect of reliefs under sections 133 to 150*

*(1) Subsection (2) applies where tax is charged, in respect of a single-dwelling interest, for a chargeable period that includes one or more days that are relievable as a result of any of the provisions listed in subsection (3) (or for more than one such period).*

(2) *For any such period, the adjusted chargeable amount is to be calculated on the basis that the chargeable person is not within the charge with respect to the interest on any relievable day.*

(3) *The provisions are—*

*section 133 (property rental businesses);*

*section 134 (rental property: preparation for sale etc);*

*section 137 (dwellings opened to the public);*

*section 138 (property developers);*

*section 139 (property developers: exchange of dwellings);*

*section 141 (property traders);*

*section 143 (financial institutions acquiring dwellings in the course of lending);*

*section 144A (regulated home reversion plans);*

*section 145 (occupation by employees or partners of a qualifying trade or property rental business);*

*section 147A (caretaker flat owned by management company);*

*section 148 (farmhouses);*

*section 150 (providers of social housing).*

(4) *See also section 106 (adjustment of amount chargeable and claim for relief)."*

14. ATED returns and payments must be made by 30 April each annual period beginning on April 1. It is necessary to complete an ATED return even if one of the reliefs applies. This creates an administrative inconvenience.

*ATED-related Capital Gains Tax*

15. ATED-related Capital Gains Tax ("ATED-related CGT") is found in section 2B Taxation of Chargeable Gains Act 1992 ("TCGA") and imposes tax on the disposal of high value properties by companies who are within the charge to ATED. The rate at which ATED-related CGT is charged is 28%. ATED-related CGT takes priority over non-resident CGT ("NRCGT").

16. In calculating what the ATED-related gain is, gains are rebased unless an election is applied to disapply rebasing, and it only applies where the

property itself is sold rather than where the shares in the company are sold.

17. If a company does not have to pay ATED in a chargeable period then it similarly does not have to pay ATED-related CGT.

*Non-resident Capital Gains Tax*

18. Non-resident Capital Gains Tax ("NRCGT") was introduced by Finance Act 2015 and expanded the Capital Gains Tax ("CGT") regime to non-UK residents disposing of UK residential property. The overarching objectives for this according to the government's consultation "Implementing a Capital Gains Tax Charge on Non-residents" were:

*"Fairness: the primary aim of the new regime is to ensure that the tax treatment of non-residents that own and make gains on UK residential property is comparable to that of UK residents.*

*Sustainability: the new regime will be introduced in a way that can be maintained without risk of significant abuse going forwards.*

*Simplicity: the new regime will be introduced in a way that minimises complexity as far as possible."*

19. Individuals, personal representatives, trustees, companies or funds are subject to CGT under the NRCGT rules if at the time of the disposal, they are non-UK resident and the disposal is of a UK residential property interest.

20. The definition is in TCGA 1992 Schedule B1 Paragraph 1:

"*1 Meaning of "disposal of a UK residential property interest"*

*(1) For the purposes of this Act, the disposal by a person ("P") of an interest in UK land (whether made before or after this Schedule comes into force) is a "disposal of a UK residential property interest" if the first or second condition is met.*

*(2) The first condition is that—*

*(a) the land has at any time in the relevant ownership period consisted of or included a dwelling, or*

*(b) the interest in UK land subsists for the benefit of land that has at any time in the relevant ownership period consisted of or included a dwelling.*

> (3) *The second condition is that the interest in UK land subsists under a contract for an off-plan purchase.*
>
> *...”*

21. Interest in UK land is defined in Schedule B1 paragraph 2 and includes (a) an estate, interest, right or power in or over land in the United Kingdom, or (b) the benefit of an obligation, restriction or condition affecting the value of any such estate, interest, right or power, other than an excluded interest.

22. The applicable rates are 18% and 28% for unincorporated persons and 20% for corporates.

*Shadow Directorship?*

23. Whilst not specifically introduced to counter the perceived problems with enveloped properties, there was (and still is) a risk that a charge to income tax could arise to a non-domiciliary under sections 97-113 of Income Tax (Earnings and Pensions) Act 2003. This was based on the benefit of the occupation if the individual was an actual or shadow director of the company.

24. The occupation would be taxable as a benefit in kind which could result in significant charges though perhaps has not arisen so much in practice.

**Has the Government achieved its goal?**

25. According to the IFF Research, despite the introduction of ATED, owners of properties through envelopes still did not want to de-envelope for the following reasons:

> *“[1] For some owners of envelopes, this was because the benefits of the envelope (IHT protection, privacy and property protection) were too important to ‘give up’ and because the cost of ATED did not outweigh these. [2] For others, the cost of de-enveloping, due to the associated CGT on disposal of the envelope, was too great.*
>
> *[3] An additional consideration was uncertainty concerning the tax landscape in general: many agents reported they had advised clients to ‘stay put’ in their envelope until there was more certainty with regards to property tax policy.”*

26. Whilst revenue raising was achieved, the ATED charge was not so high as to outweigh the IHT advantages. This is clear when one considers the amount of ATED paid and that it continues to grow:

| *Financial Year* | *£million* |
|---|---|
| 2013/14 | 100 |
| 2014/15 | 116 |

*Changes to Inheritance Tax Treatment*

27. IHT is a key driver in enveloping properties and so the government has decided to amend the IHT treatment of UK residential property which is held through an offshore structure. The draft legislation published in December 2016 was summarised as follows in the associated Policy Paper: ‘Legislation will be introduced in Finance Act 2017 to amend IHTA by inserting a new Schedule A1. The effect of the new Schedule will be to bring property within the scope of IHT to the extent that its value is attributable to a UK residential property where it is held by a non-domiciled individual. It does so by treating the interests of participators in a close company, or of members of an overseas partnership, as not excluded property for the purposes of IHT where its value is attributable to a UK residential property interest.’ The legislation also applies to ‘relevant loans’ defined as any loan to the extent that money or money's worth is made available to finance the acquisition of a UK residential property interest by an individual, partnership or trustee or the maintenance or improvement of such an interest in a partnership or a settlement. It also includes any loan used to finance the acquisition, either by an individual or a trustee, of a right or interest in a close company, or an interest in a partnership, to the extent that the loan is used to finance the acquisition of a UK residential property interest by a close company or a partnership or the maintenance or improvement of a UK residential property interest t which is owned by a close company or a partnership.

## Tax Consequences on De-Enveloping

*De-Enveloping relief?*

28. In the government’s consultation “Reforms to the taxation of non-domiciles:

further consultation (19 August 2016)” at paragraph 2.4 the government stated:

*"The IHT charge will apply to all chargeable events which take place after 6 April 2017.At the 2015 Summer Budget, the government said that it would consider the cost associated with de-enveloping of properties. However, while the government can see there might be a case for encouraging de-enveloping, it does not think it would be appropriate to provide any incentive to encourage individuals to exit from their enveloped structures at this time."*

29. In response to the consultation, some committees including, for example STEP have asked that the government reconsider a de-enveloping relief given that:

*"People with residential property in an offshore company will face both ATED and IHT. Previously they might have considered the ATED to be a price worth paying for the IHT protection. In most cases they would now prefer to dismantle the structure so that the property is in their personal ownership, but often face prohibitive CGT and/or SDLT charges in doing so. Please can renewed consideration be given to reliefs from these charges. Failing that, please can it at least be confirmed that the SDLT anti-avoidance provisions in s75A FA 2003 will not be applied in de-enveloping situations where a debt is refinanced to enable the de-enveloping to take place."* [2]

*How to De-envelope?*

30. The most common option for de-enveloping, though not the only one, is through liquidation and then distribution of the property as a distribution in specie. This will have the following tax consequences.

ATED-related CGT

31. Liquidating the company will result in a deemed disposal of the property at its current market value. Depending on the value of the company, this could result in a charge to ATED-related CGT. This will be charged at a flat rate of 28%. If the property is not charged to ATED, then it will not be charged to ATED-related CGT.

NRCGT

32. NRCGT is also a concern as a non-resident company will be subject to CGT on gains arising from the disposal of the UK property. It would

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2 http://www.step.org/sites/default/files/STEP-response-to-reforms-to-the-taxation-of-non-domiciles-October-2016.pdf

be charged at the corporation tax rate with indexation if the seller is a company on gains on the disposal accruing after April 2015.

*Section 13?*

33. There is a risk of a CGT charge on a UK resident participator under TCGA section 13:

*"(1) This section applies as respects chargeable gains accruing to a company—*

*(a) which is not resident in the United Kingdom, and*

*(b) which would be a close company if it were resident in the United Kingdom.*

*(1A) But this section does not apply if the gain is --*

*(a) an ATED-related gain chargeable to capital gains tax by virtue of section 2B (capital gains tax on ATED-related gains), or*

*(b) an NRCGT gain chargeable to capital gains tax by virtue of section 14D or 188D (capital gains tax on NRCGT gains).*

*(2) Subject to this section, every person who at the time when the chargeable gain accrues to the company is resident in the United Kingdom and is a participator in the company, shall be treated for the purposes of this Act as if a part of the chargeable gain had accrued to him.*

*..."*

34. This is subject to the motive defence in section 13(5) which is very widely drafted and likely to apply in most circumstances as the planning will have been undertaken to avoid IHT rather than CGT:

*(5) This section shall not apply in relation to—*

...

*(b) a chargeable gain accruing on the disposal of an asset used, and used only–*

*(i) for the purposes of a trade carried on by the company wholly outside the United Kingdom, or*

*(ii) for the purposes of the part carried on outside the United Kingdom of a trade carried on by the company partly within and partly outside the United Kingdom, or*

...

(ca) *a chargeable gain accruing on the disposal of an asset used, and used only, for the purposes of economically significant activities carried on by the company wholly or mainly outside the United Kingdom, or*

(cb) *a chargeable gain accruing to the company on a disposal of an asset where it is shown that neither—*

(i) *the disposal of the asset by the company, nor*

(ii) *the acquisition or holding of the asset by the company, formed part of a scheme or arrangements of which the main purpose, or one of the main purposes, was avoidance of liability to capital gains tax or corporation tax, or*

(d) *to a chargeable gain in respect of which the company is chargeable to tax by virtue of section 10B."*

Gain on Disposal of the Shares

35. The gain on the disposal of the shares on liquidation will be taxable on the shareholder. This will be at the standard CGT rates.

36. The gain is most likely to be the increase in value of the property from the acquisition and could be particularly high. Consideration will need to be given as to whether any reliefs or deductions can be made.

Off-shore trust?

37. Where an off-shore trust is involved, the taxes are potentially made more complicated.

38. Where the trust holds the property through a company, CGT may arise on the beneficiary due to section 87 TCGA though it may be possible to mitigate this liability.

*Stamp Duty Land Tax*

39. If consideration is given by the shareholders for the transfer of the property then usually SDLT will be payable; however land transactions with no consideration are generally do not attract SDLT.

40. Following section 54(4) FA 2003, there is an exception to the deemed market value rule where:

*"(4) Case 3 is where—*

*(a) the vendor is a company and the transaction is, or is part of, a distribution of the assets of that company (whether or not in connection with its winding up), and*

*(b) it is not the case that—*

*(i) the subject-matter of the transaction, or*

*(ii) an interest from which that interest is derived,*

*has, within the period of three years immediately preceding the effective date of the transaction, been the subject of a transaction in respect of which group relief was claimed by the vendor."*

41. A distribution of property in specie by a company should not attract SDLT as there is no consideration. HMRC have release guidance which is consistent with this in SDLTM04042:

*"There will be two situations where HM Revenue & Customs (HMRC) will not consider there to be any consideration given.*

*The first is where the company is debt free: its only asset is the property and there are no liabilities (other than issued share capital). In such a situation the shareholders have given no consideration directly or indirectly for the property and therefore there is no Stamp Duty Land Tax (SDLT) liability."*

42. However, in many circumstances the company will have a debt which was taken out in order to fund the purchase of the property. If there is a debt which is owed to a shareholder which is released in return for the distribution of the property then one may consider that SDLT may be payable. Paragraph 8 Schedule 4 Finance Act 2003 provides:

*"8 Debt as consideration*

*(1) Where the chargeable consideration for a land transaction consists in whole or in part of—*

*(a) the satisfaction or release of debt due to the purchaser or owed by the vendor, or*

*(b) the assumption of existing debt by the purchaser,*

*the amount of debt satisfied, released or assumed shall be taken to be the whole or, as the case may be, part of the chargeable consideration for the transaction.*

*(1A) Where—*

*(a) debt is secured on the subject-matter of a land transaction immediately before and immediately after the transaction, and*

*(b) the rights or liabilities in relation to that debt of any party to the transaction are changed as a result of or in connection with the transaction,*

*then for the purposes of this paragraph there is an assumption of that debt by the purchaser, and that assumption of debt constitutes chargeable consideration for the transaction.*

*(1B) Where in a case in which sub-paragraph (1)(b) applies—*

*(a) the debt assumed is or includes debt secured on the property forming the subject-matter of the transaction, and*

*(b) immediately before the transaction there were two or more persons each holding an undivided share of that property, or there are two or more such persons immediately afterwards,*

*the amount of secured debt assumed shall be determined as if the amount of that debt owed by each of those persons at a given time were the proportion of it corresponding to his undivided share of the property at that time.*

*(1C) For the purposes of sub-paragraph (1B), each joint tenant of property is treated as holding an equal undivided share of it.*

*(2) If the effect of [this paragraph] 3 would be that the amount of the chargeable consideration for the transaction exceeded the market value of the subject-matter of the transaction, the amount of the chargeable consideration is treated as limited to that value.*

*(3) In this paragraph—*

*(a) "debt" means an obligation, whether certain or contingent, to pay a sum of money either immediately or at a future date,*

*(b) "existing debt", in relation to a transaction, means debt created or arising before the effective date of, and otherwise than in connection with, the transaction, and*

*(c) references to the amount of a debt are to the principal amount payable or, as the case may be, the total of the principal amounts payable, together with the amount of*

*any interest that has accrued due on or before the effective date of the transaction."*

43. HMRC, however, has issued its stance in these circumstances in SDLTM04042:

"*The second of these situations will be where there is debt but this debt is owed solely to the shareholder. This is a situation that HMRC has given its views on before and we confirm that the guidance in SDLT Technical News issue 5 (August 2007) still applies. The relevant part is replicated below.*"

44. I set out the relevant extract from SDLT Technical News issue 5 (August 2007) as before relying on it, one will want to consider whether it will definitely apply:

"*Transfer of property on winding up - loan from shareowners*

*We would not seek to argue that the dividend in specie should bear SDLT in a situation for example where A owns the shares of B Ltd. A lends money to the company to buy property, the loan being secured by mortgage on the property.*

*Later B Ltd is wound up and there is a transfer to A as beneficial owner of the equity. That is the reason for the Transfer. The loan is not released etc, but obviously the mortgage will be taken off as the lender also owns the property because of the liquidation.*

*Clearly in this scenario A has not assumed any liability or given any other form of consideration*"

45. Debts owed to shareholders must be distinguished from third party debts. Where there is a third party loan secured on the property when the company is liquidated, the transfer of the property by the company on distribution will attract SDLT under paragraphs 1 and 8 Schedule 4 FA 2003.

46. HMRC recognised that given the SDLT repercussions of a company liquidating where it has a third party debt, there may be incentive to ensure that the third party debt has been repaid prior to the liquidation. If the company is already in funds and is able to repay the debt then there ought to be no liability. However, if the company is put into funds as a result of shareholder action through, for example, the subscription for more issued share capital or by replacing the third party debt with shareholder debt prior to its liquidation, it is not so straightforward. In such cases it is *possible* that on distribution of the

property there will be no charge to SDLT as it will be a distribution in similar circumstances to the first two situations outlined above.

47. However, one will want to take care as HMRC, following the First-tier Tribunal decision in *Project Blue Limited v The Commissioners of HM Revenue & Customs* [2013] UKFTT 378 (TC) that, "section 75A FA 2003 could apply where the shareholder of a company provides funds to the company to allow it to discharge its debt, before acquiring the property from the company if those actions are involved in connection with that disposal or acquisition. Whether section 75A applies will depend on the facts of each case."

48. There is therefore a risk that HMRC will attempt to challenge on section 75A grounds so care must be taken in the circumstances of a third party debt situations.

**What can be done going forwards?**

49. There are some clear advantages to de-enveloping; however, there may be high tax charges. Therefore, there is no one-size fits all approach to what should be done and therefore in each instance advisers will want to consider whether de- enveloping is the best option or if instead it is worth keeping the property in the envelope because, for example, an ATED relief may apply. Additional considerations will come into play if it is held in trust: who will potentially unrealised gains be attributed to, will there be an IHT charge. In circumstances where there is a debt one should consider whether any SDLT charge may be outweighed by an IHT saving. It will be worth considering what to do going forward to ensure that Principle Private Residence Relief will be available on a future sale.

50. It is also worth considering in the first instance whether the property in question is in fact held beneficially by the company. In some cases it may be possible to show that the property is in fact held on resulting trust for the individual concerned.

51. In considering this, one can look to cases like *Petrodel Resources Ltd v Prest* [2013] UKSC 34 at paragraph [52]:

> *"52 Whether assets legally vested in a company are beneficially owned by its controller is a highly fact-specific issue. It is not possible to give general guidance going beyond the ordinary principles and presumptions of equity, especially those relating to gifts and resulting trusts. But I venture to suggest, however tentatively, that*

> *in the case of the matrimonial home, the facts are quite likely to justify the inference that the property was held on trust for a spouse who owned and controlled the company. In many, perhaps most cases, the occupation of the company's property as the matrimonial home of its controller will not be easily justified in the company's interest, especially if it is gratuitous. The intention will normally be that the spouse in control of the company intends to retain a degree of control over the matrimonial home which is not consistent with the company's beneficial ownership. Of course, structures can be devised which give a different impression, and some of them will be entirely genuine. But where, say, the terms of acquisition and occupation of the matrimonial home are arranged between the husband in his personal capacity and the husband in his capacity as the sole effective agent of the company (or someone else acting at his direction), judges exercising family jurisdiction are entitled to be sceptical about whether the terms of occupation are really what they are said to be, or are simply a sham to conceal the reality of the husband's beneficial ownership.*"

*Future IHT Planning*

52. When UK residential property is owned by the individual, then it will form part of their estate for IHT purposes and will be subject to IHT. Ultimately what can and cannot be done will depend upon how the legislation pans out and what changes if any come as a result of the consultation which at the time of writing these notes has yet to be published.

53. Some of the standard options which have applied for UK domiciliaries ought to be considered, including for example, making use of the spouse exemption if possible in the circumstances. Those advising will also want to ensure that they advise their clients on a UK will to deal with the UK property.

54. It may be possible to consider using debts to reduce the amount of IHT as following section 5(3)(5) IHTA, where a liability was incurred for consideration in money or money's worth it shall be taken into account in determining the value of a person's estate. However, it will be necessary to consider the restrictions on loans including section 162A.