TAXREP22/13

(ICAEW REP33/13)

ICAEW TAX REPRESENTATION

HIGH VALUE RESIDENTIAL PROPERTY

Comments submitted on 22 February 2013 by ICAEW Tax Faculty in response to draft legislation and explanatory notes relating to high value residential properties published by HM Revenue & Customs on 31 January 2013 on Annual Residential Property Tax, Stamp Duty Land Tax and Capital Gains Tax

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the draft legislation on
   Annual residential property tax
   Relief from higher rate of stamp duty land tax
   Capital gains tax charge on certain high value disposals by companies etc and the associated explanatory notes
   Annual residential property tax (ARPT)
   Relief from higher rate of stamp duty land tax (SDLT)
   Capital gains tax (CGT) on certain high value disposals by companies etc.
   published by HM Revenue & Customs (HMRC) on 31 January 2013.

2. We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

3. We have previously commented on the proposed legislation in TAXREP41/12, TAXREP2/13 and TAXREP12/13 and have written directly to HMRC to ask for clarification on whether the anti-avoidance provision in s75A Finance Act 2003 will apply when companies de-envelope properties that are subject to finance (see Appendix 2).

4. Information about the Tax Faculty and ICAEW is given below. We have also set out, in Appendix 3, the Tax Faculty's Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system.

WHO WE ARE

5. ICAEW is a professional membership organisation, supporting over 140,000 chartered accountants around the world. Through our technical knowledge, skills and expertise, we provide insight and leadership to the global accountancy and finance profession.

6. Our members provide financial knowledge and guidance based on the highest professional, technical and ethical standards. We develop and support individuals, organisations and communities to help them achieve long-term, sustainable economic value.

7. The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including TAXline, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.

KEY POINT SUMMARY

8. We repeat our earlier concerns that given the length and complexity of the new legislation the proposed introduction date of 1 April 2013 is far too short a timetable. The government aim is for property to be taken out of the non-natural person structures but there is insufficient time for individuals to take advice and then to implement the advice before the legislation is effective. The time frame also means that the time given to review the draft legislation in its near final form is insufficient and it is extremely likely that problems will arise after enactment which with more time for consultation would have been resolved beforehand. Indeed even now we do not have everything. For example, the ARPT charity relief and the diplomatic purposes relief have not been published. The potentially affected charities are very concerned as they do not know if they will be covered by the relief or not.

9. Following on from this it is disappointing that no transitional provisions are introduced to deal with the difficulty of unwinding offshore trusts structures which hold non UK companies which in turn own high value UK residential property. The apparent policy behind the proposals as

outlined in the earlier consultation documents is to discourage enveloping of high value residential property, and to encourage de-enveloping of such properties. Whilst the proposals are likely to achieve the first policy objective they are unlikely to achieve the second because of the prohibitive tax costs likely to be encountered where UK residents occupy the property concerned. It was hoped that transitional provisions would be introduced to mitigate these costs. To allow more time for de-enveloping could a provision be included such that there will be no charge to ARPT and no CGT charge if the property is extracted before 6 April 2014 or before the first ARPT return is required?

10. The concerns raised in our earlier submissions are reiterated. We acknowledge that some changes and amendments have been made en route particularly with the introduction of reliefs for certain situations but the scope of the reliefs introduces yet more problems.

ANNUAL RESIDENTIAL PROPERTY TAX

11. We note that the CGT rules effectively borrow from the ARPT rules, so any shortcomings in those rules trace through to the CGT provisions.

Reliefs – general points

12. The draft legislation requires the owner to carry out the various relievable activities. The requirement will mean that relief cannot be claimed in a number of circumstances despite there being a genuine business, for example:

- the company owning the residential property may be part of a larger group and another company in the group carries out the activity.
- the property might be owned within a trust/company structure with the company having granted the trust a lease to use the property. In turn the company may allow a beneficiary to use the property and the beneficiary may carry out the activity.

13. The prohibition on occupation by a non-qualifying person should ***not*** bite where an arm's length third party rent is paid.

14. The denial of relief for "intended occupation" should be dropped – it is too subjective and will be difficult to apply.

Relief should be due where tax is paid in full on the provision of the benefit and the free use of the property is part of an emoluments package for an employee and so for the purposes of the business. As such, the provision withholding relief if the employee's interest in the employer company/partnership exceeds certain limits should be dropped.

Farmhouses draft clause 53

15. The potential problem areas include cases where land used by farming businesses is owned by companies or a company is involved in a partnership that is engaged in farming activities. In particular there are issues with the scope and the subjectivity of the definitions. It is necessary that the person who is undertaking the trade is entitled to the interest in the farmhouse but the owner of the property might not be engaged in the undertaking of the trade. Each case will need to be reviewed based on its own facts. Where this requirement is not the case and there is a connection with a corporate entity, the provisions will not be satisfied.

16. Equally the relief will not be satisfied where the 'wrong' type of farmhouse is owned. It is not clear what "of a character appropriate to a dwelling occupied in connection with the farming of the land concerned, having regard to the size of the farm and to the nature and scale of the trade carried on" actually means. There is extensive case law on what is and what is not a suitable farmhouse for inheritance tax agricultural property relief purposes but if that is used to interpret this proposed legislation we believe that a number of farmhouses would fail to qualify for the exemption – albeit it is understood that this is not the intention behind the draft legislation.

17. Furthermore, the farmhouse might be occupied by the 'wrong' type of farmer. The position is not clear where the property is occupied by a semi-retired member of the farming family. On the face of it the relief would not be available unless the involvement was "substantial". We do not believe that it is the intention of the government to force the senior members of farming families out of their home.

Dwellings opened to the public draft clause 42

18. The provisions contained in draft clause 42 of the draft ARPT legislation are aimed at protecting the position of Stately Homes owned by companies. However we are still concerned that a qualifying trade is defined as a trade carried on on a commercial basis and with a view to profit. Many such properties have extremely high running costs and the entrance fees are merely a contribution and a profit is most unlikely.

19. There is also some concern over the subjectivity and vagueness of some of the definitions, for example in sub clauses (5) and (6):

> ‘(5) For the purposes of this section persons are not taken to have an opportunity to make use of, stay in or otherwise enjoy a dwelling unless the areas that they are permitted to make use of, stay in or otherwise enjoy include a significant part of the interior of the dwelling.
> (6) The size (relative to the size of the whole dwelling), nature, and function of the area or areas concerned are to be taken into account in determining whether they form a significant part of the interior of the dwelling.',

what is meant by significant?

Interests held by connected persons draft clause 15

20. Another area of concern is in relation to property management companies that own the freehold reversions to flats occupied for residential properties, where the interests are particularly valuable. Often pepper corn rents are charged, which would cause the activity to fail to qualify as a property rental business. The position is also not clear where similarly the valuable reversionary interest is held by a connected trust, or associated company. Mr Robert Maas has supplied us with an example of how this anti fragmentation clause will impact in situations where we are quite sure it is not intended, Appendix 1.

Application of provisions, companies draft clause 63

21. We note that the definition of a proper officer of the company is defined in clause 63 (2) as ‘the secretary, or a person acting as secretary, of the company’ and that, in the case of non-resident companies, the ARPT can be recovered from the ‘proper officer’ with the facility that they can retain company’s funds to reimburse themselves. We question how workable this will be and whether non-resident entities will have someone who is classed as a ‘proper officer’ or who is prepared to assume the risk of being liable for ARPT.

Administration

22. The tax adds yet another administrative burden onto companies within a very short time frame; submission of the return within 30 days of coming within the charge.

23. It is intended that ARPT will be self-assessed but given the complexities it is unlikely that most people will be able to understand the tax provisions and correctly self-assess. In particular the rules for “look forward” and “look back” in clause 40 are convoluted and easily misunderstood. Although the scheme adopted is based on the SDLT self-assessment regime which it is claimed will be familiar to many tax and legal practitioners it will not be familiar to an individual who would only have come across SDLT on the acquisition of a property, not an everyday transaction.

24. Many of the companies coming within the charge to ARPT will be owned by non UK domiciliary. As the company will frequently have the sole purpose of owning the property there will be no cash in the company to pay the tax charge. Is it intended to extend s809V ITA2007 such that if funds used to pay the tax are from overseas it will not be treated as a remittance?

25. Is it also intended to make any transfer of funds to the company an exempt transfer for inheritance tax purposes?

CAPITAL GAINS TAX

26. There is no clear compelling reason why the rules aimed at offshore non-natural persons (NNP) should also be applied to UK resident companies. In practice these provisions will become a headache for farmers and there is no evidence, even anecdotal, that farmers are engaged in the type of SDLT tax planning activities that the rules were introduced in order to address. But what it will mean is that farmers may have to take professional advice and incur costs as a result in order to establish if or the extent to which they are caught. We believe that a much fairer solution would have been to grandfather all existing UK resident NNPs as of 5 April 2013.

27. Given that the changes are necessary such that tax rates are matched for all EU companies we trust that changes will be made to the reliefs so more companies will be outside the charge and would ask that every effort is made to simplify compliance for UK resident non-natural persons. For example, aligning the tax payment date and the return submission date with those for corporation tax where the company has to file a corporation tax return would assist.

28. It will be necessary to have valuations prepared as at April 2013 in order to calculate the gain attributable to the period from the introduction of the new charge to the date of sale. This is in addition to any valuation that may have been required at April 2012 for ARPT.

29. There are no proposals as to how the CGT will be collected from non-residents. In principle it would appear to be very difficult to enforce and arrange collection and we consider more detail should have been available as to the means of collection.

30. Companies have been used to acquire properties by non UK domiciliary as part of their inheritance tax planning rather than to avoid SDLT and, anecdotally, the property has been sold on disposal rather than the shares as the purchaser preferred not to take on the "history" of the existing company. In future, as the gain on the sale of the high value residential property will be liable to CGT it is more likely that the shares will be sold rather than the property and this is counter to the intended purpose of the new legislation.

STAMP DUTY LAND TAX

31. It is disappointing that the reliefs from the 15% SDLT charge will only come into effect after the Finance Bill has received Royal Assent. In our view the reliefs should be available at the latest from April 2013.

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APPENDIX 1

IMPACT OF ANTI-FRAGMENTATION DRAFT LEGISLATION

Information provided by Mr Robert Maas and reproduced with his permission

I do not think that my client's situation is in any way unusual. The facts seem to me to be that an old house was converted into four flats in around 1950. The developer did not own the freehold but held a 99 year lease. He granted leases of 99 years less a couple of days to occupiers in return for large premiums. He then transferred to a company owned by the occupiers his two day (or whatever) reversionary interest. Recently my client and another tenant applied to acquire the freehold under the enfranchisement legislation. As recommended by the government on the GOV.UK website (which links to Shelter), a new SPV was set up as the enfranchisement vehicle. Accordingly the property is now held:

Company B	freeholder – freehold acquired recently for around £1 million
Company A	2 day reversionary interest – worth very little (may be de minimis although I am not sure that de minimis can apply where the law requires a de minimis interest to be aggregated with a valuable one)
Individual occupiers	long leasehold interests which are very valuable.

One of the leaseholders has since emigrated and offered my client the opportunity to buy his lease and his interest in the two companies. As a result my client has a controlling interest in both companies. Accordingly both companies are treated as owning a high value residential property (albeit that the high value resides in my client's lease, not in either of the companies). I appreciate that the legislation does not impose two lots of tax; it merely makes the companies jointly liable for one lot of tax.

All of these are normal commercial transactions. No one has ever tried to avoid any tax. Because we did a circular to clients, my client has told me about the situation. If we had not done so he would have had no idea that there was a problem and I would have had no idea about the history of his flat. Most people in this situation, even if they are well read and have read virtually everything that the government has published about ARPT (apart that is from the draft legislation which Joe Public cannot reasonably be expected to study), would not know that a tax aimed at properties held by companies and from which properties owned by individuals are specifically excluded, nevertheless taxes the value of a property owned by an individual if, for historic reasons, a small interest in that property (which may itself have very little value) is held by a company. That is so counter-intuitive that no-one could be expected to recognise that they might be in such a situation.

A further example is as follows:

In the discussions on ARPT, was the position of companies owning reversionary interests looked at?

There are a number of ways in which this situation can arise. Suppose for example I form a company to develop a block of flats. I decide to occupy the penthouse myself and take a 125-year lease from the company for a premium of £2.5million. As far as I know, UK law does not have the concept of "flying freeholds" so the only way I can acquire my flat is to buy a long lease. Accordingly the company is forced to retain the freehold reversion on my lease. The value of the reversion is small but not de-minimis, say 8 years purchase of the ground rent, which will probably give a value of say, £800. Because I am a connected person of the company, clause 15(1) treats the company as owning my leasehold interest in addition to the freehold reversion. It accordingly has an annual tax liability of £15,000, but may well have no income or assets out of which to pay this.

I appreciate that clauses 14 and 15 are an anti-fragmentation provision but it does seem to me wholly unreasonable to catch this circumstance where the company is virtually forced to keep a minor interest in the property because that is the way that UK land law works. It is grossly unfair. Why should tax be payable in these circumstances whereas no tax would be payable if I had bought a house for £2.5million rather than a flat or, indeed, if I had been prepared to expose my wife and family to the development risk and done the development in my own name. When I was advised to do the development through a company some years ago to obtain the benefit of limited liability, nobody had heard of ARPT, so it was a common sense thing to do.

An even more unreasonable situation is in relation to leasehold enfranchisement. Where flats are let on long leases, a majority of the tenants can require the freeholder to sell the freehold, not to them but to an entity owned by them. The GOV.UK website advises potential enfranchisers to form a limited company as the enfranchisement vehicle. It is wholly unreasonable for the government to encourage the purchase of the freehold by a limited company and then to turn around and say that, purely because a limited company has been used at the government's instigation, it is going to impose a hefty tax charge.

This does not normally impact on large blocks of flats as there will be enough shareholders to ensure that no individual leaseholder is a connected person of the company. It is however an issue with small blocks. Suppose for example A owns one of four flats. His brother, B, owns the second and two unrelated persons, C and D own the others. A, B and C seek enfranchisement and follow the government's advice to form a company to do this. All four flats are worth over £2million. A and B are connected persons of the company, so their long leaseholds are treated as owned by the company. C is not a connected person, so his long leasehold is not. Suppose the long leases are each worth £2.5million, the company is deemed to own three interests (the two leases and the reversion) which together are worth over £5million so there is a £35,000 annual tax charge that has been brought about by following the government's advice on enfranchisement. As the late Phillip Hardman would have said, "That is a national disgrace!".

Of course the shareholders could liquidate the company and remove this problem but A and B cannot do this without the agreement of C and it is hard to see why C should agree if disposing of the freehold will attract both capital gain tax and SDLT.

I appreciate that SDLT would not arise if the reversionary interest is taken out of the company by a liquidation distribution if there are no borrowings. However, if there are borrowings, there would still be SDLT on the amount of the loan. With a block of four flats each worth more than £2million, the statutory payment to buy the freehold could well exceed £1million and it would be usual for a large part of such a price to be provided by way of a borrowing.

I think that from a common sense point of view, there should be an exemption from ARPT where the company's interest in the property is worth less than, say, 5% of the aggregate value of the interest of itself and connected persons. If the government are not prepared to do that, then there needs to be an SDLT exemption on taking the reversion out of the company. It must be unreasonable by any standard for the government to say, "Use a company to enfranchise and when that transaction has been completed, take the reversion out of the company so that we can collect two lots of SDLT".

APPENDIX 2

LETTER DATED 1 FEBRUARY 2013 TO HMRC

HIGH VALUE RESIDENTIAL PROPERTIES: REFINANCING OF BORROWING

The ICAEW Tax Faculty has been heavily involved in the various consultations on the package of measures relating to the taxation of high value residential properties; we have been represented at various meetings and submitted detailed responses.

The May Consultation Document stated that one of the Government policy objectives of the proposals was to encourage high value residential properties to be 'de-enveloped' from pre-existing corporate structures. From the beginning we have been concerned that the proposals contained nothing which would assist taxpayers to de-envelope in line with Government policy because it may trigger further tax liabilities, notably SDLT and CGT.

The particular concern we are writing to you about now is to try and resolve the uncertainty about whether the SDLT anti-avoidance provision s 75A, FA 2003 will be applied where, as part of the de-enveloping any borrowing against the property needs to be refinanced. It is likely that high value UK residential properties within a corporate structure will be subject to debt financing and as such, the HMRC position on s 75A is of crucial practical significance when considering a possible restructuring.

The HMRC position on this is not entirely clear but we understand that there have been indications that s 75A could be invoked to charge SDLT on the refinancing. We find this concerning and disappointing. We support the comments of the STEP UK's Technical Committee (reproduced in the Appendix to this letter) and wish to join them in urging HMRC to confirm publicly that s 75A will not be invoked where corporate borrowings are re-organised or discharged as part of arrangements to extract high value residential properties from corporate structures.

We believe that, given the Government's clear policy aim, it is wrong for HMRC to seek to apply an anti-avoidance rule to proposed transactions that are not being undertaken to avoid SDLT but to comply with the Government's stated policy intention. The lack of clarity in HMRC's position on this is likely to have the opposite effect to that intended and discourage de-enveloping.

It is now less than two months before the introduction of the new ARPT charge. Directors need to take detailed advice on this and implement any transactions before 1 April 2013. We believe that this timescale for implementing these measures is already far too short and have called for a longer transitional period into the new regime. If the Government insists on introducing these measures from 1 April 2013 then we think it is vital that HMRC makes an announcement about clarifying the effect of s 75A as soon as possible.

APPENDIX 3

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see icaew.com/en/technical/tax/tax-faculty/~/media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx)