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Global Family Office Conference 2019

Succession Planning for International Families with Property Interests

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Succession Planning for international families with UK Property Interests

Agenda

- Druces LLP
- Legal Concepts
- Case Study
- Succession Planning, Considerations and Opportunities
- Future purchases of UK Property
- Family Governance and Succession Planning

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Druces LLP

- Founded in 1767 City of London Law Firm
- Provide international advisory services for non-UK domicile clients both resident and non-resident in the UK
- Family office services for HNWs
- Personal, Property, Commercial, Corporate, Immigration and employment services

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Druces are a law firm based in the City of London. We take a holistic approach when advising our clients on complex tax, fiduciary and estate issues. We advise our clients in relation to Income Tax, Capital Gains Tax and Inheritance Tax, as well as Annual Tax on Enveloped Dwellings (ATED) and Stamp Duty Land . We also regularly advise non UK domiciled individuals and non UK residents and their families in relation to how their financial affairs will be treated by HMRC in the UK.

The team helps Family Offices, Trustees, Private Banks, Companies and individuals on wealth generation and preservation by bridging the gap between individuals and families and the business structures they own.

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Legal Concepts, Terms and Definitions

- Residence
- Domicile
- Capital Gains Tax
- Annual Tax on Enveloped Dwellings (ATED)
- Inheritance Tax

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You may often hear in the news the term “residence” or “domicile” used and that it is particularly favourable for someone to be “non-domiciled” or for that matter “non-resident” for UK tax purposes, but what do these terms actually mean and why are they so important?

Legal Concepts

Residence

- Residence directly affects liability to income and Capital Gains Tax
- Statutory Residence Test
- Ties to the UK
- Day Counts

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Where a client is considered to be tax resident will directly affect their liability to UK Income Tax and Capital Gains Tax.

From April 2013 the Statutory Residence test was introduced to determine whether someone is a UK resident for a tax year.

Residence is considered on an annual basis and depends on the number of days an individual spends in the UK together with the number of ties that individual has to the UK.

Ties can include whether the individual has family here, works here, has accommodation available to them, has spent more than 90 days in the UK in either of the two previous tax years and where an individual spends more days here than any other country.

Often clients say they have spent less than 90 days in the UK in a tax year and therefore are not UK resident.

However, this is no longer correct and if an individual is caught having four ties or more to the UK and were “leaving the UK” they would be restricted to fewer than 16 days. Any more days spent in the UK for that tax year could render themselves UK resident.

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Legal Concepts

Domicile

- Concept of domicile
- Domicile of origin
- Domicile of choice:
    - Physical Presence
    - Intention to remain permanently or indefinitely
    - Based of facts and intentions
- Deemed domicile

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This word is often used, but what does it mean and why is it so important?

If an individual is domiciled for inheritance tax purposes in the UK they are taxable on their worldwide estate, where as someone who is non-UK domiciled is only taxable in the UK on their UK situate assets.

Domicile is not always easy to ascertain.
Everyone has a domicile of origin at birth by reference to their parentage.

It is possible to replace a domicile of origin with a domicile of choice. Whether and when this happens depends on a mixture of facts and intention. The key elements both of which are essential for acquiring a domicile of choice are:

- Physical presence in the territory concerned
- An intention to remain there permanently or indefinitely.

Proving a new domicile of choice can often be difficult and is based on the facts available and the intention of the individual.

Prior to April 2017 irrespective of whether an individual had a domicile of choice of another but has been UK tax resident for 17 years out of the last 20 they would be considered deemed domiciled for inheritance tax purposes in the UK.

Since April 2017 this is now 15 out of 20 years. The net result of being considered deemed domiciled is that your worldwide assets are then subject to IHT.

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Legal Concepts

Capital Gains Tax

- Liability determined by reference to residence of tax payer <u>not</u> by location of asset
- Non-resident Capital Gains Tax (NRCGT)
- Recent changes to tax treatment of Capital Gains
- Timing of disposals key to planning

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Liability to Capital Gains Tax is usually determined by reference to the residence of a taxpayer and not by where the assets are situated.

In general terms an individual who is not UK resident will not be liable to UK CGT on any of their worldwide gains, even on gains that arise from the disposal of UK assets save as to a few exceptions which will be considered shortly.

By way of an example let's consider that Jose is resident in Portugal but plans to move to the UK in the tax year beginning 20/21. Jose owns some UK shares which he decides to sell. Jose will not have to pay CGT on the gain from when he acquired those shares as he is non-UK resident. In contrast if Jose sold the shares once he had become UK resident he would have been liable to CGT on the whole of the gain subject to the remittance basis.

Exceptions to Capital Gains Tax

In April 2015 the UK government introduced Non-Resident Capital Gains Tax.

Since April 2015, Non-Resident Capital Gains Tax has since applied on disposals of interests in UK residential property by non-UK residents.

This applies to disposals by any non-resident individual, trust or company which disposes of UK residential property.

This was a major change to the rules as for the first-time non-UK residents became liable to capital gains tax in the UK.

The gain is taxable from the increase in value from April 2015 until disposal although there are other methods by which the gain can be calculated.

From April 2019 the scope of CGT was extended to all UK real estate disposed of by non-residents. This includes disposals of commercial property together with the disposals of shares in property rich companies.

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Legal Concepts

Annual Tax on enveloped Dwellings (ATED)

- Finance Act 2013
- 1st April 2012 value of property affected £2million or above
- 1st April 2016 value of property affected £500,000 or above
- ATED- Related CGT
- ATED and NRCGT

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The Finance Act 2013 introduced the ATED charge whereby an annual tax charge was due for residential property held through a corporate structure depending on the value of the property.

Generally, a property will benefit for relief from ATED if it is let to a third party on a commercial basis and is not at any time, occupied (or available for occupation) by anyone connected with the owner. Commercial buy to let properties are therefore not subject to ATED.

To be exposed to ATED the value of any property had to be worth £2million (or above) as at April 2013.

Since April 2016 properties in excess of £500,000 are within the scope of ATED. This has brought a number of properties within the ATED tax net.

Also introduced was ATED-related CGT; a tax on the gain realised on the disposal of residential property which was within the ATED regime (i.e paying the ATED charge).

For the purposes of calculating the gain the base cost of the property was treated as the value of the property on 5 April 2013.

ATED and NRCGT?

For the last few years it has often been the case that on the disposal of UK residential property both ATED CGT and NRCGT have to be considered.

Provisions ensure that there is no double taxation but it has still been necessary to obtain valuations for all the relevant dates, and to compute the gain over both periods and submit two tax returns.

The widening of the NRCGT that came in April 2019 has been accompanied with the abolition of ATED CGT.

For companies disposing of UK residential property from April 2019 this means not only simpler CGT reporting but also a potential tax saving.

ATED CGT can apply to any gain since April 2013, but NRCGT only applies to gains since April 2015, so any gain that arose during the April 2013-15 period will no longer be subject to CGT.

A further saving arises from the varying tax rates. ATED CGT was payable at a rate of 28%, whereas NRCGT for companies is now subject to corporation tax rates which are currently only 19%.

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Legal Concepts

Inheritance Tax

- Scope of IHT
- Nil Rate Band
- Spouse exemption
- Impact of Finance Act 2017 Changes in Planning
- Wills

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Clients with UK connections come within the scope of IHT.

If an individual owns assets in the UK in excess of £325,000 they may have a liability to UK inheritance tax of 40% subject to the availability of the spouse exemption.

Historically it was common practice for non-UK domicillaries to own UK homes/properties through an overseas company.

This gave them ownership of foreign company shares (which is non-UK situs property) rather than owning a property outright.

Finance Act 2017
Since April 2017, UK residential property owned through an offshore company is see through for inheritance tax purposes and is therefore inside a non-dom's estate for IHT purposes.

The value attributable to IHT is not the value of the property but the value of the company's shares.
Often clients may only live in the UK for a short period of time whether it be for their children's education or a work placement with the intention of selling their UK property/assets once they move back to the country they came from.
Clients should also have wills executed as part of their succession planning to ensure spouse exemptions for IHT are fully utilised where appropriate.

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Case Study

- Husband Archie, Wife Beatrice – 2 children Charles and Darren – Non UK Domiciled and Non-UK Resident
- Shares in company held 40% each for parents and 10% each for children. In 2005 Charles aged 4, Darren aged 2
- Established ABCD Ltd May 2005 to purchase a London residential Flat
- Purchase price 2005 £2million
- Value April 2012 £3million
- Value April 2015 £3.2million
- Value Today 13th June 2019 £3.5million
- Since 2005 none of the family had any intention of moving to the UK permanently or indefinitely
- All born in Spain and have lived in Spain since birth

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Case Study:

The facts are these : - Archie and Beatrice are married and live in Spain and have lived in Spain all their life. They have two children, Charles and Darren. The family established a company called ABCD Limited in May 2005 to acquire a residential flat in London.

The company was incorporated in Jersey.

The flat's purchase price was £1.5million. In April 2013 the flat was valued at £3million and in April 2015 it was valued at £3.2million. Today's value is £3.5million.

The flat was acquired as soon as ABCD Limited was incorporated.

When the flat was acquired Archie, Beatrice, Charles and Darren were all non-UK domiciled and non-UK resident for tax purposes.

Since 2005 none of them had any intention of moving to the UK permanently or indefinitely.

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Case Study

- ABCD Ltd incorporated in Jersey
- Family are owners of the Company's shares, 40%, 40%, 10%, 10%
- Archie moved to the UK solely for work purposes in May 2016
- Archie UK resident in tax years 16/17, 17/18, 18/19
- Archie's family have occupied the flat rent free since 2016
- Archie has now finished working for the company but remains in London – no intention of remaining in the UK
- The other family members and shareholders remain non resident and non-domiciled
- Shareholders are considering liquidating ABCD Lt

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The family are owners of the Company's shares in the following percentages : Archie 40%, Beatrice 40%, Charles 10%, Darren 10%.

Archie moved to the UK solely for work purposes in May 2016 and was UK resident in the 16/17, and 17/18,18/19 tax years.

Archie's has lived rent free in the flat since he became UK resident and the flat has never been rented out.

Archie has now finished the work placement but has stayed in London since April 2019.

The other shareholders Beatrice, Charlie and Darren have always remain non-resident.

The shareholders have been considering liquidating ABCD Limited since November 2018 and are still considering their options.

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Case Study

- Tax issues and planning opportunities on liquidating ABCD Ltd
- Inheritance Tax
- Liquidation and CGT Implications
- ATED – Related CGT
- Principal Private Residence Relief
- Impact of the liquidation on the shareholders

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Consideration of various tax issues at stake since 2005 and planning opportunities that have been available to the family. Specifically looking at :

- Inheritance Tax
- Liquidation and CGT implications
- ATED – Related CGT
- Principal Private Residence Relief
- Impact of the liquidation on the shareholders

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Case Study

Inheritance Tax Issues

- Position in 2005 when property purchased
- Position post 6 April 2017

Planning Opportunities

- Planning opportunities prior to April 2017
- Planning opportunities post April 2017

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Provided the family were non-UK domiciled in 2005 the value of the property would not have been inside their estates for inheritance tax purposes as they would have been treated as owning shares in an offshore company.

Prior to 2017 this would have been a tax efficient way of structuring an acquisition of UK residential property.

However, from 6 April 2017 all UK residential property held by a non-UK domiciled individual, whether directly or indirectly is subject to IHT.

The planned liquidation of ABCD Limited should not give rise to any immediate IHT charge.
Beatrice and Archie should consider having UK wills drafted to ensure the spouse exemption is fully utilised if available.
It would also be advisable for all the family to consider the possibility of life insurance to cover any potential IHT liability whilst they still hold the property.

Owing to the valuation rules, the value of the company shares will often be less than the value of the property itself so there could be merit in considering not liquidating the company, but other tax considerations need to be taken into account which will be considered shortly.

However, it may be considered that there is little merit in retaining the company structure unless the shareholders wanted to retain anonymity.

If they now want to gift their shares they would need to survive seven years for the value of the shares to be outside of their estates for IHT purposes.

If they also decide to sell the company, they would need to survive two years for the value of the shares attributable to the property to be outside their estates for IHT purposes.

Given these anticipated changes were known about prior to April 2017, if they had sold the company prior to April 2017/gifted the shares there would have been no requirement to survive any period of time.

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Case Study

Liquidation and CGT Implications

- Non-resident Capital Gains Tax
- Consideration of ‘elections’ for CGT purposes

ATED – Related CGT

- Position as at April 2013
- Position since April 2015
- Finance Act 2019

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A liquidation of ABCD Limited entails the transfer by the company of the London Flat to its shareholders and so this will constitute a disposal for CGT purposes.

In April 2015 we would have advised the company to obtain a valuation of the property at that date.

In the absence of any election the gain arising on the disposal of the property by ABCD Limited will be the difference in value from the market value in April 2015 to the market value at the date of the liquidation.

The gain would therefore be £300,000 (3.5million less 3.2million).

ATED-related CGT

ATED CGT would have applied since April 2013 given we understand it was never rented out and Archie has lived there.

We would have advised in April 2013 that the property should if possible be rented out to a third party to prevent the Company being liable to ATED-CGT and the Annual Charge for holding UK residential property though a corporate structure.

Prior to April 2019, ATED related CGT and NRCGT potentially would have applied to the transfer of the flat to the shareholders with the former taking precedence.

It was reported in 2018 that the Finance Act 2019 would be abolishing ATED CGT.

Given the tax rates for ATED CGT were and are higher than NRCGT our advice upon seeing the proposals for the Finance Act 2019 would have been to hold off the liquidation of the company until April 2019; not only to pay the gain at a lower rate (19% instead of 28%) but also because the valuation date for ATED purposes was April 2013, whereas NRCGT was from April 2015.

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Case Study

Principal Private Residence Relief (PPR)

- Concept of PPR
- Availability of PPR
- Liability of CGT

Impact of the liquidation on the Shareholder

- Tax liability for Beatrice, Charles and Darren?
- Tax liability for Archie?
- Planning opportunities for Archie?

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The concept of PPR means that if someone has occupied a property as their main home then that period of ownership will be exempt for Capital Gains Tax purposes.

In this instance it is not available as the flat is owned by a company and not by individuals. This is so even though Archie as occupied the flat as his only or main residence.

However, if Archie decides he does want to live in the flat after it has come out of the Company structure then in theory on a further sale his share of the property could be exempt from capital gains tax.

He could also consider buying out his family members so that on a further sale (on the basis Archie continues to live there) the family do not suffer any further capital gains tax.

Impact of the Liquidation on the shareholders

We know three of the shareholders are non-UK resident and therefore aside from the NRCGT liability the liquation should not give rise to any immediate tax charges.

However, the situation is a little more complicated for Archie as he may be UK resident for the 19/20 tax year and there is a provision which can attribute gains in non-UK resident companies to a UK tax resident shareholder.

If in the current tax year when the liquidation occurs Archie is UK resident his share of the gain may go back to the original value of the property in 2005 thus creating a significant further tax liability on Archie as his 40% share will need to go back to the £1.5million value.

Planning opportunities for Archie?

Although Archie has been tax resident in the previous tax years, given today's date is 13 June and only just over two months into the tax year Archie could consider whether it would be possible for him to be non-UK resident in the 19/20 tax year to avoid a potential further tax liability as referred to. This would be possible depending on the ties Archie has to the UK and the number of days he is likely to spend in the UK for the remaining part of the tax year.

If it is not possible for Archie to be non-UK resident in the current tax year, he could consider making a gift of his shares to Beatrice who is non-UK resident.

In theory this could give rise to a charge to CGT based on the difference in value of the shares from April 2019 until today's date but this would be exempt from capital gains tax as transfers between spouses are neutral for these purposes.

Depending on Archie's future plans and when the liquidation does occur, if Archie becomes non-UK resident in the tax year of the liquidation, but then returns to the UK within a five year period he could be caught by the temporary non-residence rules which came into force in April 2013 so that any gains realised in the period of non-residence will become taxable in the year of return.

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Future purchases of UK Residential Property

- Direct Ownership
- Offshore Trusts
- Offshore Company
- Offshore Trust/Company Structure

The case study looked at an existing structure and how the various changes in legislation had an impact on it. What about future purchases of UK residential property? Clearly, families moving to the UK from overseas will naturally still need somewhere to live and they may wish to buy a home here.

Buying and owning a home in the client's own name is undoubtedly the most obvious, straightforward and transparent method of property ownership. However, for some Resident Non Dom's they do not like to own property directly to protect their identity for example. For those reasons, Resident Non Dom's have often been advised to consider purchasing their UK homes indirectly via offshore companies, trusts or a combination of both. However, in practice since the IHT rules for homes owned in corporate structures changed from April 2017, increasingly outright ownership or direct trust ownership for the family home is seen as preferable from a tax perspective to any sort of offshore structure. But if the desire to protect a purchaser's identity is the main driver, an offshore trust structure may still be useful.

It's also worth saying, that Tax is only part of the equation. Other factors should also be considered when deciding what structure works best for a particular client or family. Their time horizon, future plans, control, flexibility, are all factors to be considered, not just the tax implications.

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Family Governance and Succession Planning

- Only 12% of Family Businesses reach the 3rd generation
- *Only 3% are successfully passed onto the 4th generation
- Family governance regulates interactions between businesses, family and ownership
- Establish fair decision-making process and clear communication channels.

*family business institute

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Turning now to Family Governance and Succession Planning. Many questions about the future of the family business keep our clients awake at night. Which children should they pick to take over the business? Are they competent? Are they old enough? Would the children themselves prefer to become doctors, architects or even lawyers rather than have anything to do with the business?

As advisors to families, the family dynamics can be challenging. There is a need to understand the bonds and ties within a family whist also being aware of the business needs and finding a way of bringing it all together.

So what is meant by Family Governance?

Essentially, Family Governance regulates the interactions between business, family and ownership and puts in place fair decision making processes and clear communication channels. By providing formal forms of discussion and interaction, family members know what the rules are and what the future looks like. Solutions can range from a letter of wishes, formal shareholder agreements to full blown family constitutions or charters. Succession planning is undoubtedly one of the most difficult topics to address in family businesses.

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Family Governance and Succession Planning

- *Only 15% of family businesses have a robust, documented and communicated succession plan in place.
- A trusted advisors role is to help family business owners ensure that their ideas and future plans are discussed, documented and formalised
- Succession planning should be discussed proactively
- Recognise that succession planning is a process not an overnight event.

*PWC 2016 Family Business Survey

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According to PWC's survey only 15% of family businesses have a robust, documented and communicated succession plan in place. This isn't surprising, discussions about death, retirement, succession planning across the generations in a family are never going to be easy. Very often these issues are put on the back burner or on the 'too difficult' pile of the 'to do list'.

Understandably, business owners tend to have strong views on what the future might look like, possibly without ever having discussed these with other key members of the family. A lack of communication can be fatal to the future survival of the family business. A trusted advisor will need to help family business owners transform their ideas about the future into a plan that can be discussed and agreed in order to minimise the tensions within the family and prevent a business being governed by uncertainty.

Often we become involved as lawyers in a family business following the death of a family member and it becomes evident that no succession planning has been put in place, and decision making becomes very reactive to events, rather than being a process that could and should have happened years earlier.

Whilst an obvious point, succession planning is a process and several discussions with several key people over a period of time will be needed to ensure that any plan is sustainable and has the full buy in from everyone.

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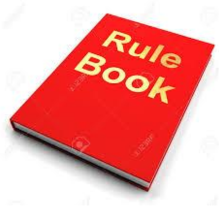
Family Governance and Succession Planning

- Facilitation of conversations between family members
- Recognise founder may have strong views
- Be prepared to listen to the next generation
- Consider how should next generation be developed, trained and mentored.
- What rules should be in place should a family member wish to sell their stake in the business?



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Conversations clearly need to take place and be facilitated in a constructive way.

Any Advisor needs to recognise that the owner of the business is likely to have strong views, it is their business after all! All family members need to be prepared to listen to others, especially the next generation as it will be their job, either as shareholders, or managers or owners to take the business forward.

Difficult questions will come up and need to be addressed. Plans need to be developed to train and nurture the next generation for example. What if a family member wishes to sell their stake in the business? Rules and agreements may need to be implemented to deal with that particular situation.

We are often involved with questions about control versus trust. At what age do you trust the next generation, at what age do you give them control?

As you would expect me to say, each family and each situation is unique and will be different. The key to successful succession planning is engagement and a willingness to find solutions. Any plan needs to be robustly tested, and also regularly reviewed and updated as the business won't be standing still and things change.

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