Non-doms and UK residential property

The latest announcement about the IHT treatment of UK residential property contains some interesting features, particularly regarding loans.

We all know that where a UK asset is owned by an offshore company, the shares in the company are foreign assets and excluded property for IHT purposes in the hands of a foreign domiciled individual.

HMRC announced last year that it intends to remove this excluded property treatment in respect of UK residential property from next April – but it did not say how this would be done. It has now.

The idea is that the shares in the offshore company will no longer be excluded property, to the extent that the value of its shares is attributable directly or indirectly to residential property in the UK.

Because it is the shares in the offshore company which will not be excluded property, it will be the value of those shares (to the extent that that value is attributable to UK property) which will be chargeable. It will therefore be necessary to value the shares, which will give rise to lots of really interesting arguments here – and opportunities.

Where the shares in the company are in a trust, some serious problems arise because of the ten-year charge and the gifts with reservation rules. Once the offshore company's shares cease to be excluded property, the reservation of benefit may apply, so that the settled property will be chargeable as part of the settlor's estate – plus (in many cases) the ten-year charge. Foreign trustees are going to love that.

A significant issue (more of a spectre) appears in connection with debts. The normal deduction for debts against the property will continue – although certain debts on UK residential property are now disallowed, particularly where the property is refinanced. Continuing this theme, it is now proposed that loans between connected parties will be disregarded when determining the value of the property chargeable to tax.

You have to feel sorry for trustees who own UK residential property purchased for (say) £5m from funds borrowed from somebody connected with the settlor. They have property which is worth zero, but they will be charged inheritance tax on the basis that they have assets worth £5m. HMRC may deem them to have this value – but that does not mean that they have money to pay the tax. I do not know what (foreign) trustees are supposed to do when faced with such a demand for tax which they obviously have no means of being able to pay.

And what if the lender was domiciled in the UK? The loan would be an asset in their estate but it would not be deductible as far as the trustees are concerned. So the trustees would be liable to inheritance tax on an asset worth £5m; and the lender would also be liable to inheritance tax on an asset worth £5m. The amount chargeable to inheritance tax is doubled. What a great trick. Do this a few times and The Deficit will disappear completely.

Maybe Mr Hammond has seen a conjuror finding a £1 coin behind his ear and thinks it really is magic. ■

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Bring on the revolution!

BEPS is only a sticking-plaster in the international tax arena. Root and branch reform is required.

We have not yet seen the really revolutionary changes to international taxation which are needed and are now becoming more urgent.

The OECD's BEPS project sets out essentially to maintain the status quo, with some limited changes to deal with certain aspects of the taxation of multinational companies. However, the fundamental structure of international taxation was not reformed: the division between residence and source taxation, the use of arm's length transfer pricing, and the sovereignty of states to design their tax system to attract investment, were all left largely unreformed. The BEPS project offered no real solutions to a number of major issues such as the taxation of the digital economy, the lack of reform of US international taxation, and the continued existence of tax havens and low tax regimes.

The BEPS project will have consequences, however. The information that will become available as a result of country by country reporting, which will almost certainly become public in the next few years, may confirm how little impact the BEPS project has had. It may confirm that the arm's length principle is failing to allocate taxable capacity in accordance with economic activities. The interest of the public and civil society groups in international taxation is not likely to diminish, and will demand reforms to the current system. The demand for more fundamental reform is likely to become irresistible.

The future is likely to see a new approach to the allocation of tax jurisdiction over multinational profits, based upon a relatively simple, formulary approach. This may not be as sophisticated as arm's length transfer pricing, but at least it will be more workable and give a result that is more publicly acceptable. The advantage of the formulary allocation approach is that there is no need to allocate any tax jurisdiction to states that do not seek to utilise their jurisdiction by imposing little or no taxation (it will be an interesting question whether states imposing less than, say, 15% tax will be regarded as not really seeking to exercise any jurisdiction at all). It will also be possible in a formulary approach to ignore all forms of intellectual property which benefit the entirety of a group, so that it will be unnecessary to recognise intra-group transfers or royalty payments for this intellectual property.

A revolution is also overdue in the international tax architecture. The OECD has already recognised that it needs to reach out and involve more countries in its global forums. At some point it will become recognised that, as the OECD seeks to become more UN-like, it would make more sense if all of the functions of the OECD were actually transferred to a new structure under the umbrella of the UN (and not the existing UN tax structure). Real reform of the international tax system requires the participation of all countries, and only an organisation like the United Nations in which virtually all countries are represented can hope to claim legitimacy for the fundamental reforms that are needed.

One consequence of the BEPS project which is inevitable is a dramatic increase in the number of international tax disputes. The real issue is not whether such disputes materialise, but whether they overwhelm the existing systems of dispute resolution. Even with the option of arbitration, dispute resolution systems may become overwhelmed and break down. The inevitability of disagreements with tax authorities, and the consequential uncertainty, is a real cost of investment in other countries and may become a substantial barrier to cross-border trade and investment.

Overall, until there is a root and branch reform of the international tax system, the current system, with its BEPS-sticking plaster, is likely to become more and more of a burden which hinders cross-border trade and investment at exactly a time when those barriers should be removed. The days of fundamental reform of international taxation are close approaching. ■

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This commentary is taken from 'Plucking the goose: a century of taxation from the great war to the digital age' (Tolley, September 2016). Tolley is donating all profits from book sales to the 'Bridge the gap' charitable campaign.