The Hornbeam Guide to UK Taxation of Overseas Property

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Introduction – General Considerations

This guide is about the implications of overseas property transactions for UK taxation of UK citizens who remain resident in the UK. However you should remember that most property transactions are taxed in the country in which the property resides. Therefore you should always take advice from an accountant qualified to advise on the taxation of the country in which the property is situated.

The second thing to remember is that most countries will have double taxation agreements with the UK. These agreements vary. The advice in this leaflet is inevitably of a general nature, and you should always take specific advice about the impact of the double taxation treaty with the country in which the property is situated.

Buying the Property

There are no UK taxes when you buy a property abroad.

Renting a Property Abroad

In our experience most Britons buy properties abroad for their own use and occasional use by family and friends. Some buy properties mainly in anticipation of making capital gains. However, a significant minority buy properties for commercial letting.

Rental profits on properties abroad are calculated in same way that profits are calculated on UK properties. However, profits from letting of overseas property are not reported with other rental income on the UK tax return. Instead they are reported as part of the Foreign Income pages. The profits arising in each country must be calculated separately for the purposes of identifying and calculating double taxation relief.

The rules for calculating the profits and losses are based on the rules for calculating profits and losses of UK rental property. These rules are set out in our brochure "The Hornbeam Guide to Taxation of Residential Letting" which can be found at http://www.hornbeam-accountancy.co.uk/?page=10930.

The key differences are:

- Profits and losses of overseas lettings must be translated back into sterling, usually at the average exchange rate for the period.
- Losses on overseas lettings are first offset against profits from other overseas lettings in the same year, then carried forward against future profits of overseas lettings (but see below).
- You need to consider personal use of the property.

- You need to be very cautious of the rules with regard to overseas business travel.
- Double taxation treaties need to be consulted (see below).

Renting a Property Abroad – Furnished Holiday Lets

In practice most overseas lettings are going to be "Furnished Holiday Lets" and the situation with FHL's and especially overseas FHL's is changing rapidly.

The definition of a furnished holiday let and more about the changes can be found on www.hmrc.gov.uk/budget2009/furnished-hol-lets-1015.pdf.

For many years Furnished Holiday Lets in the UK were taxed significantly differently to most other forms of letting. Much emphasis is put on the advantages:

- Profits from FHL are relevant income for Pension purposes.
- Capital Allowances can be claimed for furnishings etc.
- Losses can be offset against other income.
- Certain capital gains reliefs (including business asset roll-over relief, entrepreneurs' relief, relief for gifts of business assets, relief for loans to traders and exemptions for disposals of shares by companies with a substantial shareholding).

However there were no comparable advantages for Overseas Furnished Holiday Lets to which normal rules for taxation of rents applied. By the time of the 2009 Budget the government had realised that this distinction was in contravention to EEC law. That budget therefore introduced two changes:

- With immediate effect Overseas Furnished Holiday Lets situated in the EEC would be entitled to the same tax treatment as UK Furnished Holidays Lets.
- From 2010/11 the whole Furnished Holiday Lets regime is to be withdrawn!

So this means that for UK residents letting overseas property, the 2009/10 tax year may be something of a one-off opportunity to apply the FHL rules. This might be particularly attractive if you;

- Have bought a lot of furnishings and equipment and would like to claim capital allowances,
- Have losses that you would like to offset against UK income,
- Want to take advantage of the relevant earnings rules to boost your pension contributions or,
- Can utilise UK Capital Gains Tax reliefs on the sale of a property.

Renting a Property Abroad – Personal Use of the Property

If you own a holiday property abroad you almost certainly want to use it yourself. This means that for tax purposes there is going to be some element of "private use".

Now let us assume that the property is let for 20 weeks and is used by the family for 4 weeks, but stands empty for 28 weeks. The tax inspector could argue that the property is only let for 20 weeks of 52 and so 32/50 of the costs should be disallowed, in practice he is unlikely to be that mean and will probably say that 4 weeks of 24 weeks actual use is private so 4/24ths of the costs should be disallowed. We would always argue that the property is <u>available for letting</u> 48 weeks of the year and that therefore only 4/52 of the costs should be disallowed.

Renting a Property Abroad – Travelling Abroad

Another problem that can beset the UK based overseas property owner is the draconian rules concerning business travel.

The problem is with the first principles upon which British tax law is based, namely that business expenses are allowed if they are wholly and exclusively for the purposes of the business. Thus the costs of overseas travel have been disallowed for a farmer (and his wife) who, after travelling to Canada to buy livestock, stopped off in New York for a long weekend on the way home, and for a solicitor who, after attending an international conference, took a few days holiday!

Strictly, any trip which is solely for business purposes can be claimed for, but in general we would say that if you take the family and stay for a week or more, you fall foul of the dual purpose rules and the travelling will not be allowed.

Rental Income – The Double Taxation Treaties

The double taxation treaties overrule the general principles set out above, so you must always consult the treaties. In the rest of this section we consider the treaties to the top 3 destinations identified in the March 2010 issue of "A Place in the Sun".

Rental Income – The Double Taxation Treaties – Spain

What the treaty says

DT17605 – DT: Spain: double taxation agreement, Article 6: Income from immovable property

(1) Income from immovable property including income from agriculture or forestry may be taxed in the Contracting State in which such property is situated.

(2) The term `immovable property` shall be defined in accordance with the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

(3) The provisions of paragraph (1) of this Article shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

(4) The provisions of paragraphs (1) and (3) of this Article shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of professional services.

and

DT17553 – Spain: Income from property

Individuals who own property in Spain and who are not resident in Spain pay Spanish income tax in respect of the deemed rental value of their Spanish property. This Spanish tax is not creditable against United Kingdom income tax liability because there is no UK tax payable in respect of the deemed Spanish income.

Where Spanish income tax is payable in respect of actual income from a Spanish property and actual rents are taxed in the United Kingdom the Spanish tax payable may be credited against the UK payable on the Spanish rental income.

The charge to Spanish capital tax in respect of the value of the property may be deducted in computing the amount of the Spanish rental income with an appropriate adjustment for private use of the Spanish property.

The Exchange of Notes concerning the taxation of time share rights referred to at DT17550 in most cases removes the liability of United Kingdom residents to Spanish tax in respect of their ownership of Spanish time shares, except where the owner is a developer or trader in time shares. Any enquiry concerning the application of the Exchange of Notes should be referred to HMRC, Customs & International, Tax Treaty Team.

What it means

If you have property in Spain the Spanish Government are entitled to tax you on any income arising from that property (and they will), but there is nothing to prevent the UK authorities taxing you on income arising from property in Spain (as well).

Spanish tax will be credited against any tax you have to pay in the UK on Spanish property income.

If you own a Spanish property but remain resident in the UK the Spanish government will tax you on deemed rental income – as there is no equivalent tax in the UK there is no credit for this tax.

Spanish capital taxes (like UK rates) are an allowable expense in computing profits for the UK tax return.

Rental Income – The Double Taxation Treaties – Florida (USA)

What the treaty says

DT19935 – DT: USA: Double taxation agreement, Article 6: Income from real property

- Income derived by a resident of a Contracting State from real property, including income from agriculture or forestry, situated in the other Contracting State may be taxed in that other State.
- The provisions of paragraph 1 of this Article shall apply to income derived from the direct use, letting, or use in any other form of real property.
- The provisions of paragraphs 1 and 2 of this Article shall also apply to the income from real property of an enterprise.

What the treaty means

The Authorities in the US are entitled to tax any income arising from property owned in the US by a resident of the UK.

And what isn't in the treaty

The UK will still tax a resident of the UK on income arising on US property, but will give you credit for taxes payable in the US.

Rental Income – The Double Taxation Treaties – France

What the treaty says

DT7304 – DT: France: double taxation agreement, Article 5: Income from immovable property (1) Income derived by a resident of a Contracting State from immovable property (including income from agriculture and forestry) situated in the other Contracting State, including income derived from rights attached to such property, may be taxed in that other State. (2) (a) The term \`immovable property\` shall, subject to the provisions of sub-paragraphs (b), (c) and (d) below, have the meaning which it has under the law of the Contracting State in which the property in question is situated. (b) Shares or rights in a company or legal person, the assets of which consist mainly of immovable property situated in one of the Contracting States, shall be treated as immovable property situated in that State. For the purposes of this provision, immovable property pertaining to the industrial, commercial or agricultural operation of such a company or legal person or the performance of independent professional activities shall not be taken into account. (c) The term \`immovable property\` shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. (d) Ships and aircraft shall not be regarded as immovable property. (3) The provisions of paragraph (1) shall apply to income derived from the direct use, letting, or use in any other form of immovable property. (4) The provisions of the preceding paragraphs shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent professional activities.

What the treaty means

The Authorities in France are entitled to tax any income arising from property owned in France by a resident of the UK.

And what isn't in the treaty

The UK will still tax a resident of the UK on income arising on French property, but will give you credit for taxes payable in France.

Summary – Rental Income – the Double Tax Treaties

There is a clear pattern emerging above… In each case, a UK resident owner of an overseas property has to pay taxation in the country in which the property is resident, and has to pay UK tax on any income from the foreign property, but gets credit for the overseas tax against their UK tax liability.

This is the normal pattern set out in the OECD model double taxation treaty, but you must check the treaty for the country in which your property is situated.

Selling a Property Abroad

UK Capital Gains Tax is charged to its residents on gains made anywhere in the world.

The tax can be avoided by emigrating and staying out of the country for 5 years (see the Hornbeam Guide to Taxation for Emigrants), and this may appeal to many owners of overseas properties.

The basic tax charge is 18% of the gain less an annual exemption of £10,100 per person in 2009/10.

It is important to keep a record of all;

- Legal and professional costs including agent's commissions on both purchase and sale,
- Duties equivalent to stamp duty and,
- Improvement Costs

as these are allowable costs when computing the gain subject to Capital Gains Tax.

Perhaps the most important thing is to consider the double taxation treaties.

Capital Gains Tax and the Double Taxation Treaties – Spain

What the treaty says

DT17612 – DT: Spain: double taxation agreement, Article 13: Capital gains

(1) Capital gains from the alienation of immovable property, as defined in paragraph (2) of Article 6, may be taxed in the Contracting State in which such property is situated.

(2) Capital gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing professional services, including such gains from the alienation of such a permanent establishment (alone or together with the whole enterprise) or of such a fixed base, may be taxed in the other State.

(3) Notwithstanding the provisions of paragraph (2) of this Article, capital gains derived by a resident of a Contracting State from the alienation of ships and aircraft operated in international traffic and movable property pertaining to the operation of such ships and aircraft shall be taxable only in that Contracting State.

(4) Capital gains from the alienation of any property other than those mentioned in paragraphs (1), (2) and (3) of this Article shall be taxable only in the Contracting State of which the alienator is a resident.

What the treaty means

If you are resident in the UK and sell a property in Spain you are liable for Capital Gains Tax and property sales taxes (for example those equivalent to stamp duty) generally.

What happens in practice

You pay property sales taxes in Spain. In the UK you have to calculate Capital Gains Tax. Spanish flat rate taxes such similar to stamp duty will be allowed as a cost, Spanish Gains Tax will be allowed as a tax credit against UK taxes.

Capital Gains Tax and the Double Taxation Treaties – Florida (USA)

What the treaty says (HMRC website says)

DT19871 – United States of America: Capital gains

By contrast, the new treaty provides that gains will be taxable only in the country in which the person disposing of the property is resident, except for
gains arising from the disposal of real property situated in the other country;

gains arising from the disposal of the business property of a permanent establishment
In these cases the country in which the real property or permanent establishment is situated has the primary right to tax.

So relief from double taxation is achieved by giving sole taxing rights to the residence country or, where the source country can still tax the gain, by the residence country giving credit relief.

Although the article is based on the OECD Model article it includes additional provisions to deal with specific types of gains such as those arising on the disposal of shares deriving their value or the greater part of their value from real property situated in the UK or the US (the "securitised land" provision) and those realised by temporary non-residents.

What the treaty means

If you sell property in the USA the US authorities have the primary right to levy property and Capital Gains Taxes. You will still be liable for UK Capital Gains Tax but will receive credit for US Gains Tax.

Capital Gains Tax and the Double Taxation Treaties – France

What the treaty says (HMRC website says)

DT7313 – DT: France: double taxation agreement, Article 13: Capital gains

(1) Gains derived by a resident of a Contracting State from the alienation of immovable property, as defined in paragraph (2) of Article 5, which is situated in the other State may be taxed in that other State. For the purposes of this provision the second sentence of paragraph

(2)(b) of Article 5 shall not apply.

What the treaty means

If you sell property in France the French authorities have the primary right to levy property and Capital Gains Taxes. You will still be liable for UK Capital Gains Tax but will receive credit for French Gains Tax.

Summary – Capital Gains Tax – the Double Tax Treaties

There is a clear pattern emerging above… In each case, a UK resident owner of an overseas property has to pay gains taxation (and flat rate taxes like our stamp duty land tax) in the country in which the property is resident, and has to pay UK tax on any gains from the sale of foreign property, but gets credit for the overseas gains tax against their UK tax liability.

This is the normal pattern set out in the OECD model double taxation treaty, but you must check the treaty for the country in which your property is situated.

Buying the property through a UK resident Ltd Company

In general the overseas taxes on rents or gains will not be avoided by purchasing the property through a UK resident limited company (but guess what, you need to check the double tax treaty!).

In the UK tax will be paid at the Corporation Tax rate (all else being equal this is 21% at the time of writing) on rental profits – which might represent a tax saving. If there are no rentals, the UK tax authorities will no longer tax the directors on the Benefits of use of an overseas property owned by a UK resident company, provided some strict rules are adhered to.

Gains are taxed differently within companies. Companies can still claim indexation of the purchase cost as a relief, but get no annual allowance and pay tax at the Corporation Tax rate.

Companies also cost money to set up and to run; not least they have to submit detailed accounts to Companies House every year.

None the less there are some significant advantages with buying an overseas property through a company:

- More complex division of ownership can be catered for.
- Transfers of ownership are relatively simple (although not necessarily tax free).
- It may be possible to avoid local property taxes (ie Portugal).
- It may be possible to avoid local forced heirship rules (ie France).

In each of these cases you need advice from an accountant based in the country in which the property is resident as well as from a UK based accountant.

In Summary

Unless you are intending to rent out your overseas property you should not have to worry about UK tax until you come to the point of selling the property. Then it is worth taking advice.

If you rent the property, usually you will be subject to local taxes and to UK taxes, although the UK authorities will give you credit (relief from double taxation) for the taxes paid in the foreign country.

The extracts from the double taxation treaties are copied from HMRC.gov.uk/manuals/dtmanuals/index.htm and are subject to crown copyright.

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