

A place in the sun?

Trends in the ownership of UK foreign property

November 2006

Grant Thornton 



Lombard Street Research

Investments
Property Selling
Exchange rates
MORTGAGES
Place in the sun
Snowy chalet Villa
LOCAL TAXES
Principal private residence
Chateau Domicile
NON RESIDENT BUYING
Bricks and mortar
Interest rates Abroad

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Introduction

Rob Withecombe, Head of Entrepreneur and Private Client
at Grant Thornton



Welcome to Grant Thornton's analysis of foreign property ownership by UK individuals, published in association with Lombard Street Research.

We Brits love bricks and mortar. Our long love affair with property is well documented. Strong house price inflation over the past few years has fuelled interest in the domestic market such that residential property is perceived as much as an investment as a home. Between 1997/98 and 2005/06, average house prices in the UK rose by 162%.

Unsurprisingly, mortgage lending has seen very strong growth too. It seems that we Brits love to borrow.

There's no place like overseas

As the operators of cheap flights will testify, our interest in property does not stop on UK shores. With the world feeling ever smaller, and with greater opportunity and flexibility to invest overseas, more of us are turning our attention to foreign property ownership.

Yet, while we dream of a place under the Mediterranean sun; a chalet in the snowy Alps or that "absolute bargain" in some hard to pronounce place in Bulgaria, the boring old financial, tax and legal considerations of purchasing a property are often forgotten.

The risks that people take when it comes to buying property abroad never cease to amaze me. It is one thing to decipher the €24 set menu in a foreign restaurant and end up with something "unusual"; it is something else altogether to single-handedly navigate the vagaries of foreign banking covenants and local property laws in locations where property is a snip at £200,000. What do they put in the Sangria to make us act like that?

Planning ahead makes sense at every stage. But not everyone takes advice – and if they do, it is often too late. I have lost count of the times I've had to tell clients that buying a property in a company, as advised by the local Notary (who often acts for both sides) in order to "save local tax" or to "help the vendor", is really not a good idea.

Our analysis starts by considering recent trends in ownership and the motivation for buying property abroad. It goes on to explore and explain the tricky rules of residency and domicile. It looks into the various valuable tax reliefs that are available for individuals buying property overseas and outlines some simple steps for minimising tax bills on foreign property ownership. We conclude with a real-life case study and an invaluable checklist for the would-be overseas property buyer.

Living the foreign property dream is all about setting off on the right foot. Amid increased scrutiny of foreign property ownership by the UK's tax authorities and the growing complexity of our ironically entitled "self assessment" regime, Grant Thornton's purpose is to help you get it right. Here's how.

Rob Withecombe, Head of Entrepreneur and Private Client

Foreign property ownership – recent trends and future developments



Lombard Street Research

Hardly a night goes by without one TV channel or another bombarding us with programmes about buying property abroad. Foreign property ownership has indeed ballooned in recent years. Our estimates show that 2% of the British population owns a property abroad. The typical owner, identified in this report, is either a pensioner with their main residence abroad or an affluent person above the age of 45 owning a second home abroad as an investment or as a holiday home. With the global house price boom, the value of foreign property ownership has also surged, reaching £71 billion in 2005 from £29 billion in 1997. Benign global conditions have underpinned the explosion of interest in buying a foreign property. But these conditions are not here to stay. The investment demand for foreign property is likely to peter out if the global house price boom comes to an end. Social factors also underpin the demand for foreign property. Forecasting such trends is difficult.

Number of British people owning a property abroad

The people who buy property abroad can be split into two broad categories – those who own it as a second home and those who emigrate. Data on second homes abroad is available from the Survey of English Housing (SEH), carried out for the Department for Communities and Local Government. The SEH provides data on the number of English households that own a second home outside Great Britain for the past ten years. Our adjustments convert this data to represent the whole of the UK (see Appendix I on page 29 for details). In 2005, 280,000 UK households owned a second home abroad, double the number of households in 1998 when a clear upward trend began. The typical second-home owner is between 45 and 65 years old and has an income well above the average for the UK economy.

Since the early 1990s an increasing number of British people have also decided to live abroad. A large proportion of these emigrants have sold their UK homes and retired abroad. The SEH survey does not cover these people. One way of estimating the number of British people living abroad is to focus on the retirees as the Department of Work and Pensions produces data on the number of people who draw British pensions overseas. At the start of 2006, this number stood at 1.03 million, up from 770,000 in 1997. Unfortunately, this data includes both British nationals and foreigners who are entitled to receive a British pension. However, the database contains other data that allowed us to produce a rough estimate of the number of British nationals receiving a pension abroad (see Appendix II on page 31 for details). Our estimate is 666,000 people in 2005, up from 467,000 ten years ago.

Combining these two groups leaves us with a rough estimate of 1.2 million Britons owning a property abroad in 2005¹. This represents around 2% of the total population and 2.5% of the population aged 16 and over.²

1 We assume that households which own a property abroad comprise two people who own the property jointly. The figure we calculate excludes people whose foreign property is their sole residence and who do not receive a state pension.

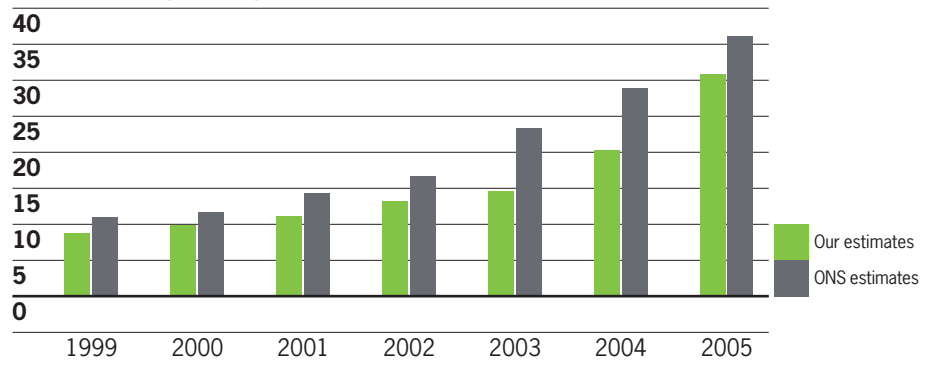
2 The number for the British population excludes the emigrants who are British nationals, but it is a useful reference.

Value of UK foreign property ownership

Taking the number of households that own a property abroad, it is possible to calculate the total value of UK foreign property ownership. For the purpose of the National Accounts, the use of the SEH methodology is a good enough method. We obtained its data, but also calculated our own estimate, improving on the methodology of the Office of National Statistics (ONS) (see Appendix III on page 32 for details). By our estimate, the value of second homes abroad was £30.9 billion in 2005 (the ONS estimate was £35.7 billion), almost four times the value in 1999 when the boom started. The ONS data is also available quarterly. Its data shows a steady rise in foreign property ownership, with the value reaching £39.1 billion in the second quarter of 2006, up by 20% on the year after a 21% increase in the first quarter³.

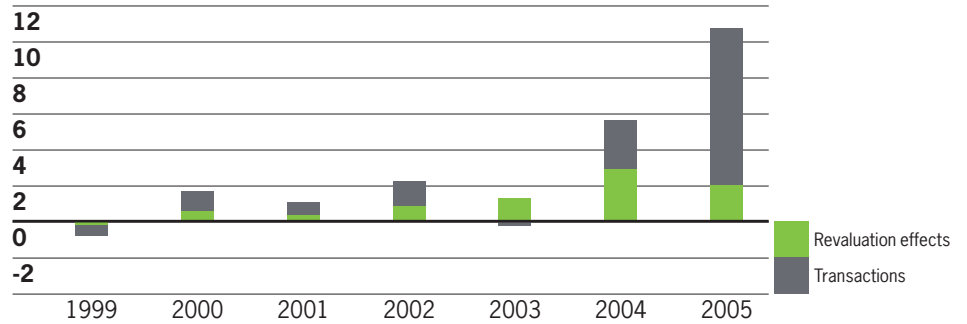
We can in fact be more specific about this, breaking down the rise in the value of foreign property ownership between new purchases and the revaluation of the existing stock of property. Such revaluation occurs through two channels – changing house prices (ie determined by local house markets conditions) and fluctuating exchange rates (determined

Figure 1: Our estimates vs ONS estimates for the total value of UK second homes abroad (£ billion)



Source: Lombard Street Research and Office of National Statistics

Figure 2: Breakdown of the change in value of foreign property (£ billion)



Source: Lombard Street Research

globally). For 2005, we estimate that new purchases amounted to £8.7 billion out of a total increase of £10.7 billion. Revaluation of the existing stock added £2bn to the value of foreign property owned by UK citizens, the vast bulk of which occurred through the first

channel, with strong house price growth in France and Spain. Over the period for which we have data, new purchases accounted for, on average, 70% of the increase in foreign property value.

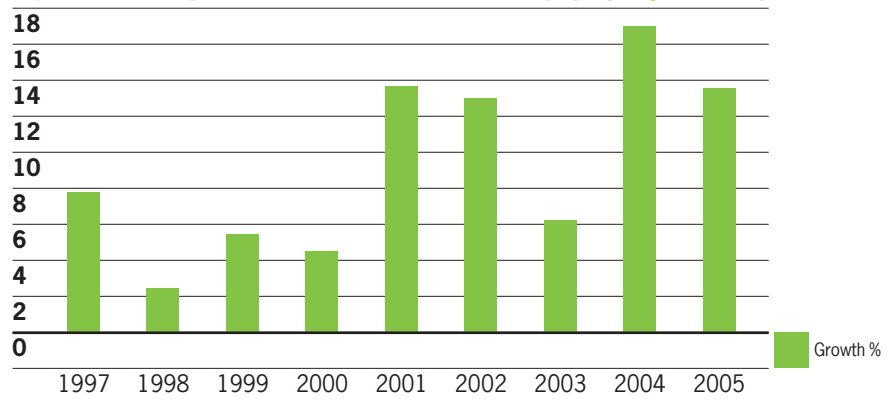
³ ONS estimates are larger than our estimates throughout the data series because they apply Europe-wide average house prices to all European countries. For 2005, average European house prices were £137,000 whereas they were only £100,000 in Spain and £116,000 in France. This simplification therefore significantly overvalues the stock of second homes in these two countries, which together account for 60% of the total stock.

We extended these calculations to include British nationals who live abroad and own foreign property as their main residence and who are not, consequently, captured by the SEH survey. The value of foreign property owned by this group is estimated to be £39.8 billion in 2005, up by 13.7% from 2004 when it grew by 17%. The total value of foreign property ownership was £70.8 billion in 2005, almost two and a half times higher than in 1998.

Reasons behind the surge in foreign property ownership

It is no coincidence that the beginning of the boom in foreign property ownership dates back to 1998. Since then, the overriding reason behind the global fall in interest rates and the rise in asset prices, notably house prices, has been the emergence of the excess Eurasian savings. In simple terms, there are a bunch of countries around the world that save way more than they invest domestically. They have to find another home for their huge savings. With no willing recipients, the global economy would have been depressed. This excess savings phenomenon emerged with particular force after the Asian financial crisis in 1997. Luckily for the global economy there have been willing borrowers. Generally, it has been the Anglo-Saxon economies that have been most willing to borrow – the US being the main recipient with the UK also playing a part. As a result we have had the “Goldilocks” economy. We had low interest rates. We had rising asset prices. And the world economy was booming.

Figure 3: Annual growth in the total value of UK foreign property ownership



Source: Lombard Street Research

But consider this in terms of the effects on globalisation. It is only in the past 15 years that, as a consequence of increased trade and capital flows, the global economy has begun to extend beyond the developed world. Bolting on the huge populations of China and India to the global economy has boosted the price of existing assets, such as houses, and lowered the price of manufacturing goods. Another factor, also likely to have contributed to low interest rates, is the improvement in monetary policymaking. Giving the Bank of England independence has increased its credibility. It has done a sterling job so far at keeping the economy operating close to its potential, but the real test is yet to come.

Historically low interest rates and the global house price boom are certainly the key macroeconomic reasons behind the surge in foreign property ownership in the UK. Financial liberalisation has also played a role, with UK lenders prepared to offer favourable mortgage rates for second homes and their EU counterparts boosting mortgage lending amid increased deregulation. One cannot underestimate, of course, the unpleasant British weather but that has not changed dramatically in the past 15 years. According to the SEH, there are two main reasons cited by respondents for owning a second home. It is an investment (40% in 2004) and it is a holiday/retirement home (38% in 2004).⁴ Other factors which made foreign property ownership easier are the emergence of cheap airline travel and the expansion of the EU.

⁴ The SEH survey discontinued the option to cite investment as a reason in 2005.

Spain is by far the most popular location, with 35% of UK households owning a second home there. France is second choice with 24%, followed by the US at 5%. But other European and other non-European countries each make up 18% of the total. Traditional holiday home destinations face increasing competition from newcomers such as Bulgaria, Romania, Hungary and the Czech Republic. The expansion of the EU has provided these low-income countries with a legal and administrative credibility that they would not otherwise have had.

When it comes to retirement, the Anglo-Saxon economies are the most popular destinations. Australia, Canada and the US top the table, accounting for half the retirees on state pensions. Spain and France are also very popular destinations. In the case of retirees, the simple fact is that house prices elsewhere are considerably cheaper while these countries simultaneously offer either the same or better quality of life.⁵

The future of UK foreign property ownership

Identifying the factors behind the surge in UK foreign property ownership allows us to analyse likely future trends. When it comes to second homes, investment tends to be a key reason that has grown in importance. SEH data shows that the number of people citing investment as the main reason for buying a second home grew from 30% in 1999 to 40% in 2004.

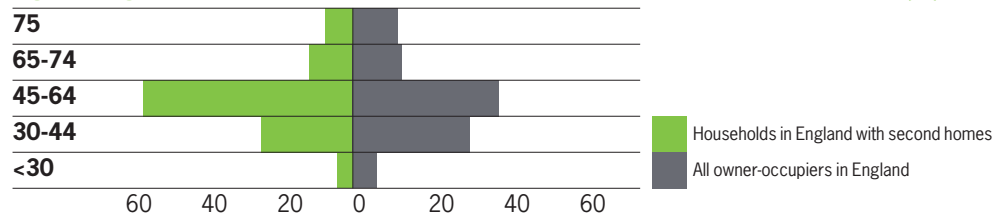
However, the current boom in global house prices is under threat. The “Goldilocks” economy described earlier led to the build-up of huge financial imbalances in the world. Their unwinding is likely to involve a sharp correction in the US, China and the other Asian Tigers in 2007. The US housing market has already slumped. Meanwhile, there has been a sustainable improvement in Japan’s domestic demand, which translated into a squeeze on global liquidity. It will continue to improve, weighing on global asset prices.

Spain, which is the most popular destination for second homes, is likely to see a sharp correction in house prices in the next couple of years. House prices remain affordable, but oversupply is set to undermine the Spanish housing market. A halt in the global house price boom, with falls probable in certain hotspots, is likely to dampen the investment demand for second homes for a couple of years. However, falling house prices in popular retirement destinations may have the opposite effect if the decline is perceived as temporary and people rush to enter the market at cheap prices. When it comes to second homes abroad, their current value relative to the overall housing wealth of UK households is negligible at around 2%. Hence, any macroeconomic effects in the UK of a house price crash in Spain, for example, will be negligible.

⁵ But different pension arrangements are an important point to bear in mind. For those retiring outside the EU, the state pension is not indexed for inflation. This is a big disadvantage, especially when large inflation differentials between the two countries are not reflected in the exchange rate.

But the effects of UK housing wealth developments on demand for foreign property ownership are important. Our UK housing affordability index shows that at these levels of interest rates and incomes, house prices are affordable. The UK housing market is set for another good year in 2006. But should it continue its uninterrupted advance at these levels, the danger of house prices becoming a bubble in 2008-2009 is real. Falling household wealth, with housing accounting for about 60% of total wealth, will be bad news for the demand for property abroad.

Figure 4: Age distribution of households with second home and of all homeowners, 2004 (%)



Source: Department for Communities and Local Government

Demographic changes, expected over the next ten years, could be positive for second home demand. Around 70% of the heads of households who own a second home are currently aged 45 and over. Demographic forecasts predict that in the next ten years there will be a significant increase in this age group, with up to 46% of all households aged 45 and over in 2015 compared with 42% in 2005. But whether these households will be in a rush to invest or retire abroad is unclear.

In terms of affordability, this decade is likely to continue under the spell of excess Eurasian savings, keeping interest rates low. But the next decade should see the structural elements behind the savings glut disappear as the Asian economies develop their financial systems and pensions and medical and social safety nets, discouraging excessive savings and encouraging domestic spending. Meanwhile, Anglo-Saxon economies will be left with huge domestic debts. Inflation could return as the build-up of Western debt to Asia collides with the crystallisation of the baby boomers' pension problem. Growth could be blighted for years. If this is the case, the current trends with respect to second home purchase and retirement migration may not continue, let alone accelerate, as some analysts predict.

Owning property abroad – a growing factor of UK life

Mike Warburton, Senior Tax Partner, and Maurice Fitzpatrick, Senior Tax Manager at Grant Thornton

The Lombard Street Research (LSR) analysis finds that UK nationals who own property abroad fall into two distinct categories:

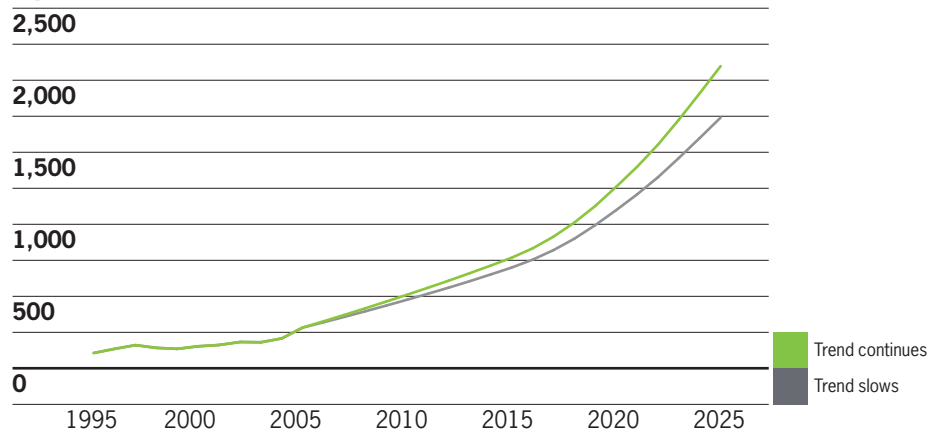
- UK resident households that own one or more properties abroad (around 280,000 households in 2005, or in the region of half a million people)
- UK nationals who have emigrated permanently from the UK to live abroad (around 350,000 households, or in the region of 660,000 people).

A place in the sun?

LSR's figures show, over the past ten years, that thousands of UK nationals have been attracted by the lure of a warm climate, a cheap cost of living and easy access to a second home overseas. The number of households in the UK owning property abroad has almost trebled from 102,000 in 1995 to an estimated 300,000 in 2006.

This has to be seen in a historical context. Sixty years ago, just after the war, property ownership abroad was limited to a relatively small number of wealthy people. Often these had inherited a family holiday home overseas. But 60 years of (relative) peace and prosperity, during which time the UK economy has broadly trebled in size in real terms, have created circumstances that make property ownership abroad an increasingly realistic prospect for many people.

Figure 5: Total UK households with a second home abroad



Source: Lombard Street Research and Grant Thornton

The incoming Conservative government's abolition of exchange controls in 1979 accelerated the trend. As a result, almost 2% of UK households that already own their own property in the UK (either outright or via mortgage), now own property overseas. Other things being equal, we would expect the figure to increase over the next ten to 20 years. Anecdotal evidence suggests that many more people aspire to own a second home overseas than have yet taken the step to do so. There is an unfulfilled demand in the UK population.

The main motivations for purchasing a property abroad are:

- as a holiday home
- for investment
- a second home to relocate to in the future, probably in retirement
- as a base for carrying out business or hobby activities abroad.

The value of UK privately owned housing (before deducting debt) is around £3.5 trillion, which means that the gross value of properties owned abroad is, at £30 billion, still relatively modest. This merely emphasises its potential to grow further. Indeed, most people who bought their first property in the UK at least ten years ago are now in a position to acquire a property overseas if they wish. This is a consequence of rising UK property values.

What is more, we are stuck for space on this crowded island of ours. In the UK, supplies of land for building purposes are restricted by policy, even though this is being relaxed, to a limited extent, under the present government. Immigration by those of working age is pushing up demand for property which, on simple supply and demand ratios, makes UK property prices high compared to our overseas neighbours.

In France, for instance, there is almost four times the amount of land for a similarly sized population, so it's not surprising that property prices seem relatively low over there. It's a comparable story in Spain. It is this that makes Spain and France two of the most popular destinations for overseas property ownership.

Unfortunately, it is all too easy to be seduced into the attraction of overseas property ownership and to ignore the perils.

Ignore tax at your peril

Purchasing a property abroad has important tax implications. Contrary to popular belief, you are still subject to tax on your offshore income and capital gains if you are UK resident and domiciled. And, if the UK tax system is not complicated enough, the purchaser of a property abroad has to cope with a local tax system that may be culturally dissimilar to our own. Elsewhere in this report we consider these issues in depth.

- Richard Proctor considers tax residence and inheritance tax – issues that are especially important to people planning to emigrate from the UK at some stage

- Sheena Hay and Alexandra Hart investigate the UK tax implications of owning overseas property
- Justin Rix looks at how tax systems operate in some of the more popular second home destinations
- a case study, based on one of our clients, looks at the various steps involved in home ownership overseas and provides a guide to personal financial planning.

A common problem arises where lawyers in the overseas country advise on a course of action – say ownership through a company – which could be highly detrimental from a UK tax perspective. Or vice versa.

Take the forced heirship rules in France. These are an important consideration yet we do not have an equivalent in the UK. Also worthy of consideration is whether to draw up a separate will in the country in which you have chosen to buy a second property. This can help avoid probate issues in the event of your death.



Mike Warburton, Senior Tax Partner

Aside from the tax traps, there are many tax planning opportunities that can be missed. For instance, many people forget that capital gains relief through the Principal Private Residence (PPR) rules are just as applicable to a second home in Spain as they are to a holiday cottage in Devon. Ignorance or delay could cost tax saving opportunities.

And, of course, don't assume that emigrating out of the UK means you immediately drop out of the UK inheritance tax net. It could take several years.

How do I pay for my overseas property?

Do I buy with cash, or do I borrow? If I borrow, should I do so in Sterling or in Euros?

The general rule of thumb is that you should borrow in the same currency from which income will be generated to pay the mortgage. This reduces the risk.

So, if the property is entirely for your personal and family use, any borrowing costs will be paid out of your earnings or investment income which will probably be UK-based. In such circumstances, borrowings ought to be in Sterling. If, on the other hand, you expect to let out the property and generate a rental stream in, say, Euros, that is the currency in which you should borrow.

As we explore later, loan interest can be set against rental income from the property to reduce your UK tax bill. It may also reduce the tax bill in the country in which the property is located. If you are not going to let out the property, there is no particular benefit in borrowing unless you can make a better return on the money elsewhere. The calculation obviously works better for let property because of the tax relief available.

British nationals emigrating to live abroad: A mass exit?

LSR's analysis suggests that there is a growing number of British nationals who have decided to live permanently abroad. In the region of over 660,000 people have emigrated (up by around 40% over the last 10 years). Nonetheless, this increase has been at a considerably lower rate than the increase in numbers of people buying second homes abroad. Clearly there are a number of factors that people take into account when considering a permanent move abroad, not least of which are:

- the opportunity, in many cases, to "trade down" to a smaller value property than previously owned in the UK
- a better climate
- a more relaxed and easier lifestyle, in many cases.

Healthcare and property

The advantages of a permanent move overseas need to be balanced against issues such as healthcare (an increasingly significant concern as people get older) and personal factors such as less contact with friends, children and grandchildren. If you are planning to leave the UK permanently, and if you can afford to do so, it may be worth keeping your house in the UK as a backstop in case things don't work out overseas. If you do not, you may find yourself priced out of the UK market.

State pensions

Typically British nationals who emigrate cannot transfer their accrued rights to a UK state pension into the overseas system. They can, however, receive the UK pension in their new country of residence. There are tax treaties in place with the majority of countries which get around the problem of double taxation.

Where you have a full contribution record, you can continue to receive your state pension. In most cases this will be uplifted each year with inflation as it is for UK residents. Unfortunately, and due to a quirk of history, this does not apply to many of the most popular destinations that were formerly part of the British Empire. For countries such as Canada, Australia and South Africa, for instance, the state pension is frozen at the level that you first take it when you reach your state pension age. This is deeply unfair to many elderly people, but the government has so far resisted lobbying on the grounds of cost.

Occupational pensions

If you have contributed to a pension while working in the UK, you will have obtained UK tax relief in the process. It may be surprising to learn that it is possible, in the right circumstances, for your pension pot to transfer with you overseas and for you to avoid suffering UK tax when the pension is drawn. This does not mean, of course, that you avoid tax on the pension in the country concerned. That is a separate consideration.

In the recent “Pensions Simplification” legislation, the administrative aspects of transferring pension benefits overseas were to have been made easier. They haven’t. They remain anything but simple.

The ways in which different countries fund their private pension arrangements are completely different. They have grown up over time and are based upon the relevant tax laws within the respective countries. For instance, the general principle in the UK is that there is tax relief on contributions and fund growth is tax free but that the majority of benefits are taxed as if they are income. In much of mainland Europe, pension arrangements operate more like savings schemes where tax relief is not available on contributions but the benefits are tax free.

Case in point

Consider the transfer of a pension from the UK to Australia. Although at first the two pension systems appear broadly similar, it is, nonetheless, a very complex process. Entirely different tax aspects depend upon the nature of the contract in the UK; the nature of the contract into which the transfer is being made in Australia; the nature of employment in Australia; and whether employer contributions were being made. In addition, entirely different treatment of the fund is dependent on whether the individual transfers before or after being resident for 12 months.

It is a general principle that pension funds should only be transferred into a pension scheme in another country where it is intended that the individual will become permanently resident and have paid employment there. In effect, you can make the transfer only if it is for genuine employment overseas.

An unusual opportunity is said to arise with unsecured income (drawdown) in France. Consider the case of Mr Smith with pension benefits in Britain within a “drawdown” contract. He moves to become a permanent resident in France making the contract taxable under French law. As it is not an annuity, rather the drawing of benefits from a pension arrangement, French law treats this as return of capital. Accordingly, no tax is payable. Clearly, this is advantageous when considering that the UK pension fund will have been accumulated without any tax. If, however, Mr Smith had opted for an annuity, or to transfer his fund to a French scheme, this favourable treatment would not apply.

In all cases, advice should be sought from a professional firm of advisers who are part of an international network.

This presents particular issues when attempting to transfer between pension arrangements in different countries. There is no rule of thumb and every situation must be treated on its own merits. It is important that advice is sought from professionals who are experienced in pension matters in both countries.

Future trends – more and more property ownership overseas

We anticipate that the trend of a gently rising number of people deciding to leave the UK permanently and live abroad (upon retirement) will continue. Were it to persist at the same rate as over the past ten years, then by 2025 there could be around 1.3 million British nationals firmly settled in another country and drawing a pension. This trend will be upheld by the growing problem of overcrowding – the UK population is set to surge above 60 million for the first time and will affect people's day-to-day lives.

Yet several factors could mean that the rate of overseas home ownership is not sustained at the levels seen in the past ten years. We see no clear reason why the recent rate of increase should accelerate. However, any continued increase is heavily dependent on the strength of the UK property market. This is because the wealth impact of the UK property market, together with the resulting liquidity generated by borrowing on that wealth impact, normally plays a significant role in influencing people to buy overseas.

As LSR concludes, there are concerns about the prospects for UK economic growth, but we are encouraged by the continued ability of the Monetary Policy Committee (MPC) of the Bank of England to steer the economy safely through future problems. This may include the potential political instability that may arise in the event of a hung parliament in the next General Election. What is more, there is an ever-growing demand for housing. As the population increases and households disperse, the supply of housing is limited by a combination of land shortage and convoluted (albeit largely necessary) planning processes. While this imbalance of supply and demand continues, which we believe it will for the foreseeable future, UK house prices would appear to be underpinned.

Our conclusion is that ever more people will be able to turn the aspiration of owning a second home abroad into reality. On this basis, we think the trend of the past ten years will broadly continue, perhaps at a slightly slower rate. The result, by 2025, could be that some 1.5 million to 2 million households in the UK will own a property abroad. But, even so, this would still only equate to one-tenth of UK property owners.



Maurice Fitzpatrick, Senior Tax Manager

Why tax residence and domicile matter

Richard Proctor, Tax Partner at Grant Thornton

Residence and domicile impact how much an individual pays in UK taxes. Careful consideration of status, to establish liability (if any) to UK taxation, is a must for anyone thinking about a move abroad.

Residence

An individual is generally regarded as UK resident if:

- present in the UK for 183 days or more in the tax year, or
- visits the UK on average 91 days or more each year for four consecutive tax years.

In respect of the second residency test, days spent in the UK for exceptional circumstances beyond the person's control, such as sickness (either your own or that of an immediate family member), are excluded from the calculation. In calculating days spent in the UK, the normal rule is to exclude the days of arrival into and departure from the UK.

Although the 183 or 91-day rules are often cited, they are taken from HM Revenue & Customs' (HMRC) booklet IR20 and are without statutory authority. Furthermore, if you cannot prove that you have "left the UK", then residency for fewer than the stipulated days may not be sufficient to rid you of UK resident status. Take the case of *Shepherd v R&C Commrs*, where a British Airways pilot believed he had relocated to Cyprus in 1998 only for HMRC (and subsequently the courts) to hold that he had, in fact, remained resident in the UK for tax purposes. While Mr Shepherd satisfied the quantitative tests, he did not satisfy the qualitative test which forms the basis of the IR20 statement. In other words, Mr Shepherd had not shown that he had "left the UK".

A person can be resident in more than one country at the same time meaning that an individual cannot escape UK taxes simply by being resident elsewhere. Where there is dual residency, double taxation agreements may apply, meaning that the individual has to check the nature of the inter-country agreements to ascertain residency status.

Strictly, an individual is taxed as UK resident for the whole of the tax year even if resident for just part of it. However, where the individual leaves the UK part way through a tax year, that year may, by concession, be split.



Richard Proctor, Tax Partner

Non-residence

If considered non-resident and where there is no UK employment, an individual's UK tax liability is normally restricted to tax on:

- UK source "personal" income such as UK bank account interest, UK dividends and rental income from UK property
- capital gains where the individual falls within the temporary non-residents rules.

Provided that you are a UK, Commonwealth, Republic of Ireland or European Economic Area citizen, you will be entitled to your income tax personal allowance. Tax allowances are also available to present or former employees of the British Crown; UK missionary society employees; civil servants in a territory under the protection of the British Crown; residents of the Isle of Man or the Channel Islands; former residents of the UK that live abroad for the sake of their own health or the health of a member of their family who lives with them, and widows or widowers of employees of the British Crown. In addition, a personal allowance may be permitted where an individual is resident in a country with which the UK has a double tax treaty.

On becoming non-resident, existing Individual Savings Accounts (ISAs) may be retained but no further investments into those accounts are permitted. It should be noted that income from Personal Equity Plans (PEPs) and ISAs may be subject to tax abroad.

Domicile

For people planning to move abroad, domicile is important in determining your liability to tax – most notably to inheritance tax (IHT). If domiciled in the UK, you will be liable to IHT on your worldwide assets. If not domiciled here, you will be liable to IHT on assets held in the UK only.

Domicile should not be confused with nationality or residency, although both can indicate where you are domiciled. Broadly speaking, domicile is determined by your permanent home or where you feel you belong. With one notable exception (see "deemed domicile" overleaf), there is no statutory definition of domicile. It is a concept of general law and is based upon the facts of each case.

All individuals acquire a domicile of origin at birth. This is not necessarily where you were born, but is the domicile of your father (or mother in the case of unmarried couples). Women married prior to 1974 automatically adopted the domicile of their spouse. If the husband subsequently changes domicile, the wife's position is then considered separately.

Individuals can, after their 16th birthdays, seek to change their domicile of origin by adopting a domicile of choice. To establish a domicile of choice you must generally sever all ties with your previous domicile and settle in the country whose domicile you wish to adopt with a clear intention of remaining there permanently. Anything that indicates that you intend, one day, to return to your former home or that you do not intend to remain permanently in your new domicile can be sufficient to prevent you acquiring your domicile of choice.

The recent Court of Appeal decision in *Agulian & Anor v Cyganik* illustrates how difficult it can be to lose your domicile of origin. The case concerned the domicile of the late Andreas Nathanael who was born in Cyprus in 1939 and moved to England in 1958 where he mainly lived until his death 43 years later. During that period, Mr Nathanael lived in Cyprus for two years but was otherwise based in London. Even though Mr Nathanael's business activities were based in London and his two daughters born there, the Court of Appeal held that he was domiciled in Cyprus at the date of his death. As summarised by Lord Justice Longmore: "A domicile of origin can only be replaced by clear, cogent and compelling evidence that the relevant person intended to settle permanently and indefinitely in the alleged domicile of choice".

Deemed domicile

An individual automatically acquires a deemed domicile in the UK, if:

- resident for tax purposes in the UK for at least 16 complete tax years out of the past 20 or
- if actually domiciled in the UK in the previous three years.

An individual with a deemed domicile in the UK is liable to IHT on worldwide assets even though he or she may not be treated as domiciled for income tax and capital gains tax purposes. People leaving the UK should note that it takes at least three years for the loss of a UK domicile to become effective for IHT purposes. However, some double taxation agreements (notably with France, Italy, India and Pakistan) override the deemed domicile rules.

Wills

UK wills cover worldwide assets. For some it may be prudent to restrict a UK will to UK assets only. A second will can be drawn up in the country in which the individual lives to cover any assets there and to make the administration of an overseas estate more straightforward.

UK property

If you rent out your UK property it will generate UK-sourced income which may create a UK income tax liability. In addition, where an individual is abroad for six months or more, basic rate tax should be withheld from the net rental profit and paid to HMRC on a quarterly basis unless a formal request is made on Form NRL1 to receive the rents in full.

If a UK property is sold at a gain, there is generally no tax liability in the UK provided that the property is occupied, throughout the period of ownership, as a main residence. In addition, some periods of absence are allowed without triggering a UK capital gains tax liability, together with the final three years of ownership. Note that selling your home may trigger a tax charge in your new country.

Individuals who hold assets in the UK but who are resident elsewhere can realise assets with large gains and avoid UK capital gains tax. This is subject to certain qualifying criteria. It should be noted, however, that the gain may be subject to tax in the new country.

While maintaining a property in a new country can be a key factor in determining an individual's residency, a property that is retained in the UK will remain liable to UK IHT irrespective of whether the individual is deemed UK-domiciled or not.

Intra-spouse transfers

Married couples who have (or acquire) separate domiciles should note the potential effect on intra-spouse transfers. Transfers of assets to a UK-domiciled spouse (including a deemed domicile spouse) are covered by the normal IHT exemption

However, transfers to a non-UK domiciled spouse have a restricted exemption of only £55,000 on cumulative transfers throughout the entire marriage. Any transfers in excess of this amount will, to the extent that they are not covered by another exemption, be potentially exempt

transfers. A potentially exempt transfer only becomes exempt if the donor survives the gift by seven years.

It is generally not possible to avoid IHT by gifting an asset from which you continue to benefit (known as a gift with reservation of benefit). Such a gift is effectively ignored and remains in your estate for IHT purposes. The reservation of benefit rules do not generally apply to gifts from one spouse to another.

However, where a UK-domiciled individual makes a gift to a foreign-domiciled spouse, the spouse exemption is restricted to £55,000. A gift in excess of that limit will fall within the scope of the gift with reservation of benefit rules.

Some practical tips before emigrating

It is important to seek detailed local tax advice before emigrating as tax regimes differ around the world and as explored above, moving abroad may not extract you entirely from the UK tax net.

Before leaving, contact HMRC and you will probably be required to complete form P85. As well as enabling HMRC to gather information about where you are emigrating to, it means you can claim a refund for any overpaid income tax.

If you continue to own and rent out a UK property following your emigration, you will be required to complete a UK self-assessment return. Otherwise, your UK sources of income, whether tax is collected at source and if income exceeds any personal allowance will determine whether or not you need to self-assess.

Buying a property abroad – the UK tax considerations

Sheena Hay and Alexandra Hart, Senior Tax Managers
at Grant Thornton

Just owning and managing one property is time-consuming enough. Buying a second or multiple properties complicates matters further still. But, if one of these properties is abroad, the additional complexities of dealing with another country's rules and customs can turn it into an absolute minefield. By dealing with the potential financial and tax planning obstacles at the outset, the headache of overseas property ownership can be mitigated.



Understanding your residence and domicile status is a primary consideration when considering the purchase of a property abroad (see the article on page 12 of this publication). For the purposes of this article, we consider overseas ownership from the perspective of a UK domiciled and resident individual and look at the tax implications of owning properties in more than one country. However, this is not exhaustive and individuals should consider their own circumstances and seek appropriate professional advice.

Capital gains tax considerations

For individuals looking to purchase a second property as an investment or as a second home, the tax on any capital gain is a very important consideration.

Private residence relief was estimated to cost the government £12.5 billion in the tax year 2005/06.

Principal private residence relief

For main residences a valuable relief is available, known as principal private residence relief (PPR). PPR relief can significantly reduce and, in some cases eliminate, any capital gains tax (CGT) on the sale of the property. This relief does not necessarily have to be on a UK property so, in certain circumstances, a foreign property can qualify for CGT relief in the UK.

PPR relief will be denied altogether if the sole aim of the purchase is to make a profit. Similarly, it can be restricted if you later make improvements to the property with the sole intention of making a gain. PPR relief can also be restricted if, for instance, you have not lived in the property continuously over your period of ownership; if you have let any part of the property out; or if you have used any part of the property exclusively for business purposes. Up to half a hectare of land is included in the relief. For areas larger than this, HMRC will decide if this is in accordance with the “size and character” of the dwelling house.

Sheena Hay, Senior Tax Manager

Exemptions

Where a residence has been a principal private residence for a proportion of the total time of ownership, the relief is calculated on a time apportioned basis (period of occupation/total time of ownership).

When a property has been an individual's PPR at some point during its ownership, it is automatically deemed, for the purposes of this relief, to be the individual's principal residence for the last 36 months of ownership.

In addition, certain periods of absence can be deemed occupation for PPR relief. These include:

- any period(s) that do(es) not exceed a combined total of three years
- if the owner is working abroad
- a period of less than four years during which the owner is required by his job to live elsewhere in the UK.

These periods are deemed to qualify where the property was occupied as the only or main residence both before and after this period.

Letting relief

In addition to PPR relief, there is another valuable relief called letting relief. If a property has been an individual's PPR at some point but it has also been let out, it should also qualify for letting relief which can help reduce any gain not covered by the PPR exemption. The amount of letting relief will be the lower of the PPR relief, or the gain attributable to the period when the property was let or £40,000.

This £40,000 is available to anyone with a share in the property. So a couple (married, unmarried, or civil partners) holding the property jointly each get up to £40,000 in relief.

Make an election

If an individual owns more than one property, he/she has up to two years or from the date of acquisition of the second property to elect which property qualifies as their PPR. The individual must occupy this residence as their only or main residence at some point.

A married couple or registered civil partners living together must make a joint election in respect of one property only. Therefore, two individuals owning separate residences who marry or enter into a civil partnership, have a two-year notification period that commences after the date of the marriage or civil partnership.



Alexandra Hart, Senior Tax Manager

If an individual has owned two properties for more than two years and has not made an election, there may still be an opportunity to do so. Some surprising “triggers” open up the period in which an election can be made. As already indicated marriage can potentially open up the window of opportunity as can the purchase of an additional property. And even when renting out another residence, there is, depending on the circumstances, the potential to make the election.

A change is triggered not only by purchase but also by sale. As already stated, foreign properties qualify (ie the relief is not territorial). Even if you have missed the deadline and the gain has already been computed and the tax paid, Extra Statutory Concession, ESC D21 allows for late claims. This might be used where you were previously unaware of the need to make an election. However, HMRC may not apply this concession and it is best to take advice.

Taper relief

Taper relief acts to reduce gains made by any individual UK taxpayer. There are two different categories of relief (business and non-business asset taper relief) which are available over two different periods – either two years for assets qualifying as business assets or ten complete years of ownership for non-business assets. So, if you have not fully extinguished a gain with PPR relief and letting relief, taper relief may reduce it further.

Figure 6: Taper relief

| Gains on business assets¹ | | | | |
|---|------------------------------------|-------------|------------|---------------|
| Number of complete years for which asset held | Equivalent % rate for taxpayers at | | | |
| | % of gain chargeable | higher rate | lower rate | starting rate |
| Less than 1 | 100 | 40 | 20 | 10 |
| 1 | 50 | 20 | 10 | 5 |
| 2 or more | 25 | 10 | 5 | 2 |

| Gains on non-business assets | | | | |
|---|------------------------------------|-------------|------------|---------------|
| Number of complete years after 5 April 1998 for which asset held ² | Equivalent % rate for taxpayers at | | | |
| | % of gain chargeable | higher rate | lower rate | starting rate |
| Less than 3 | 100 | 40 | 20 | 10 |
| 3 | 95 | 38 | 19 | 9 |
| 4 | 90 | 36 | 18 | 9 |
| 5 | 85 | 34 | 17 | 8 |
| 6 | 80 | 32 | 16 | 8 |
| 7 | 75 | 30 | 15 | 7 |
| 8 | 70 | 28 | 14 | 7 |
| 9 | 65 | 26 | 13 | 6 |
| 10 or more | 60 | 24 | 12 | 6 |

1 The definition of business assets is complex and advice should be sought on asset classification

2 Assets held on 17 March 1998 are deemed to have been held for one year at 5 April 1998 for the purposes of this relief

Source: Grant Thornton

Taper relief is applied after you have claimed other reliefs and offset any capital losses. “Ordinary” UK rental property, investment property and foreign property attract non-business asset taper relief which is slower to accrue and at a less generous rate than business asset taper relief. Non-business asset taper relief reduces the gain so that a taxpayer paying tax at 40% pays an effective rate of 24% after ten complete years of ownership, with no relief until the asset has been owned for three complete years.

Business asset taper relief applies to UK property qualifying under the Furnished Holiday Lettings regime where it is treated as though it is a business. In this case, after two complete years of ownership, any gain on the property may be reduced to an effective 10% rate for a taxpayer paying tax at 40%.

Income tax considerations

Rental income

Letting out a foreign property can help subsidise the costs of ownership.

All rental income must be declared in the UK if you are resident here and the foreign pages of the self-assessment return must be completed. If the property is held jointly (as joint tenants), rental income must be halved for the purposes of completing tax returns. In addition, you will need to consider the tax position in the country in which the property is located. However, if tax is paid on rental income there, you should receive a credit for the foreign tax against your UK tax bill.

There are various additional income tax reliefs available on rental income, for both UK and foreign properties.

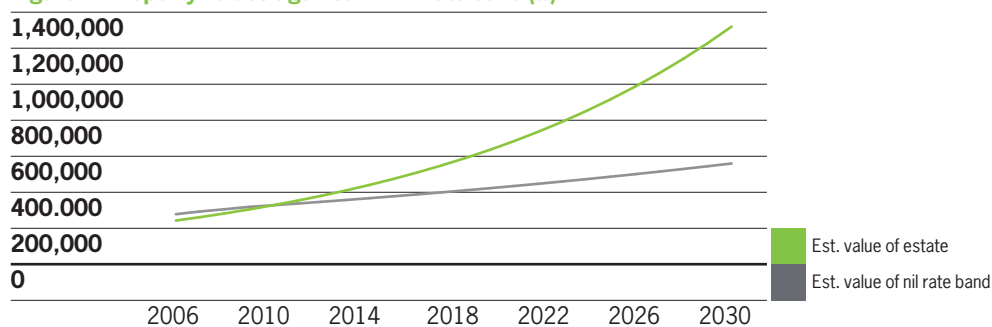
Expenses

Expenses, such as those listed below, can be deducted against your income when calculating your tax bill. This applies only where those expenses are wholly and exclusively incurred for the purposes of renting the property.

- rents, rates, insurance and utilities
- repairs, renewals, gardening and cleaning
- legal and professional costs, including agent's fees
- capital allowances.

If the owners choose to occupy the property themselves for a period of the year, then expenses allowable for tax purposes will be calculated on a time-apportioned basis.

Figure 7: Property values against IHT nil rate band (£)



The model assumes nil rate band inflation of 2.8% beyond 2009/10 and asset price inflation of 7.5%
Source: Grant Thornton

A 10% “wear and tear” claim can also be made on furnished property. Alternatively, a renewals basis can be used where the actual cost of renewing furniture and furnishings less their scrap value, if any, can be claimed as a tax deduction.

Offsetting interest on mortgage payments against tax

In the case of loan interest, relief is given even if the borrowings are raised by securing the debt against a different asset. It is the purpose of the loan that gives rise to the tax relief so, if the loan is used to acquire a property to be rented out as a rental business, the interest on that loan will be deductible. Relief is, however, only available on borrowings up to the purchase price/improvements made to the property.

Inheritance tax considerations

Domicile status, as discussed in the article on page 13 determines the extent of the impact of UK inheritance tax (IHT). It is important to remember that IHT may also apply in the country in which the property is located. This could result in an overall higher IHT bill. Local advice should be sought at the time the property is acquired.

Business property relief (BPR) and Agricultural property relief (APR)

As their names suggest, BPR and APR reliefs exist to relieve gifts of business property or agricultural property from UK inheritance tax. A UK or foreign rental business would not ordinarily qualify for relief if held personally – this is because they are only taxed as though a business whereas they are, in fact, investment income for UK tax purposes. In some instances, if these businesses are carried on through an otherwise trading company, some BPR can be obtained. This is a complex area and no relief will be available if only rental properties are held in a company. Other tax liabilities may be increased if a UK company holds investment property.

Planning options – type of ownership

UK property ownership rules mean that individuals can hold property either as tenants in common or as joint tenants. Where property is owned as joint tenants, it automatically passes on death to the survivor, irrespective of the terms of the will. However, where property is held as tenants in common, you may dispose of your share as you please. As the same legal concepts may not apply to property owned abroad, individuals need to determine the most suitable type of legal ownership for them and understand the impact it may have on their estate.

Corporate ownership

Many individuals have owned foreign property via a company, usually offshore. They might be appointed directors of that company, but if not they invariably act as directors. Although there can be certain tax benefits from owning property via a company, including the potential to circumvent the “forced heirship” rules in place across much of Europe, it is not as straightforward as it appears.

The forced heirship rules may require that the deceased’s estate is divided equally among his or her children, irrespective of the provisions of any will. Consequently, using a company, where shares can be gifted, has often been promoted to foreign purchasers as a tax planning idea.

Purchasing via a company can sometimes lead to foreign tax savings on the initial purchase, although this is being gradually eroded over time. The straightforward corporate structure is more likely to benefit the vendor than the purchaser in most cases.

Take a French property. Historically many UK residents buying a holiday home in France purchased it via a corporate structure – a Société Civile Immobilière (SCI). The principal benefits for the UK resident and domiciled individual is that it avoids the forced heirship rules that operate in France meaning that “shares” in the property can be disposed of in accordance with the owner’s wishes.

The structure is also transparent for income tax and capital gains tax purposes. So it gives the advantages of individual ownership plus the opportunity to reduce the registration duty payable on the purchase of shares compared with the purchase of property. This can prove more flexible where the property is owned by several parties.

The drawbacks of corporate ownership

Until the cases of *Dimsey v Regina* and *Allen v Regina* at the House of Lords in 2001, many UK residents found owning foreign properties through companies an attractive proposition. But, following the ruling in these cases, there is a risk that HMRC may make a benefit-in-kind charge on a UK resident who owns a property through a company and continues to have use of it.

The benefit-in-kind is based on the annual value of the property and is calculated according to the basis on which the property is made available to the individual. The definition of “made available” is much wider than simply calculating the days spent at the property. The starting point is that the property is “available” all year.

Take a property worth £150,000 when first occupied. The benefit-in-kind would be in the region of £8,250 each year. Then deduct the amounts paid for the use of the property, say £3,000 (the company might use this for the running costs). An individual could end up with a benefit of £5,250 which, for higher rate taxpayers, means an annual tax bill of £2,100 simply for using their own property.

Reducing the benefit in kind charge

There are various options for structuring the ownership to reduce or avoid the benefit-in-kind charge. The best option depends on the individual’s domicile status for inheritance tax purposes and local laws. Professional advice should be taken.

Offshore trusts

Offshore trust structures can provide significant IHT benefits to settlors (individuals who place property into trust), who are non-domiciled and are not treated as “deemed domiciled” at the time the settlement is made. Essentially, the offshore assets are excluded if not liable to UK IHT, and will continue to be treated as excluded even if the settlor subsequently becomes “deemed domiciled”. The rules surrounding offshore trusts are complex and specialist advice is recommended.

Owning the property jointly with children

If inheritance tax is a major concern, then owning a holiday home together with your children can enable you to retain some control and, most importantly, use of the property. It will, furthermore, remove the value owned by your children from your estate for inheritance tax purposes. Provided that the children have their own set of keys and the gift is absolute, you can all enjoy the holiday home property without triggering an income tax charge under the new previously-owned assets regime or without having the whole value included in your estate on your death. Professional advice needs to be taken to set this up correctly from a legal and tax perspective.

If not properly structured, a transfer of property by an individual who continues to make use of it falls within the gift-with-reservation-of-benefit rules for UK IHT purposes. In such circumstances, the property is still deemed part of the settlor's estate for IHT.

Funded Unapproved Retirement Benefit Schemes (FURBS)

If you are lucky enough to have a pre-A Day (6 April 2006) FURBS, then purchasing a foreign holiday home through this structure may be an attractive option. The UK capital gains tax and income tax position is akin to personal ownership but, whereas the property held personally will be included in your estate for IHT purposes, the asset in your FURBS is, from day one, outside of your UK estate.

There is the added benefit of access to the capital at a later date should your circumstances change.

Even if your FURBS lacks sufficient funds to purchase a property, you may be able to “gear” the property or other assets in the fund to purchase the property without being caught for adding funds post A-Day, as these may not be classified as a contribution. Care needs to be taken and, as always, professional advice should be sought.

Avoiding currency exposure

To obtain tax relief on loan interest for buying a rental property, it does not matter whether the property is purchased using a loan in the country where the property is located or from elsewhere.

Currency risk applies to all assets and liabilities. It is often wise to match the currency of your assets with your liabilities so that any fluctuations in currency exchange rates do not adversely affect your finances. For example, if the property is to be let, you could take out borrowings in the overseas currency.

If you are funding the purchase out of UK income, then it will be sensible for the loan to be in sterling.

Implications of owning properties in more than one country

Whether it is to escape to warmer climes, either now or in the future, or a consequence of an increasingly saturated UK property market, we are investing in foreign properties in greater numbers than ever before.

Based on Lombard Street Research's figure, 280,000 UK households owned a second home abroad in 2005. The most popular places to buy are Spain, France, Portugal and Italy. But before you jump on the foreign property bandwagon, you need to be fully aware of not only the UK implications but the foreign tax regimes when deciding where to buy. While initial influencers might include climate, cost of the property and perhaps cheap and easy flights to your destination, local and national taxes along with local customs and the legal system need to be given equal weight.

Caveat emptor: “Buyer beware”

There are many traps and pitfalls primed for those looking to buy a property abroad but there are commercial and tax opportunities too. With the tax regimes in European countries steadily tightening, the “opportunities” once used to coax UK investors into foreign property purchases, using corporate structures in order to minimise tax liabilities, have all but evaporated.

Allied to this, the added UK complications that can arise from using a company as a purchasing vehicle mean that UK residents need to think very carefully about how they own a property abroad. Even if the structure is not currently caught by legislation and case law, it may well be in the future. To get the best from both regimes, take advice, upfront, in both the UK and your chosen country. Only then can you properly understand your obligations and potential liabilities and, with the right advice, take advantage of some of the opportunities.

On your guard: the overseas tax implications

Justin Rix, Senior Manager – Expatriate Tax Specialist at Grant Thornton

If hearts were to rule heads, factors such as property prices, the climate and cheap air fares would govern where you bought your overseas home. But buyer beware. The tax costs which arise when buying, owning, letting out and selling a foreign property need to be factored into the decision-making equation too. And they vary significantly from country to country.

In some countries, income received from renting out a property may give rise to local taxes. In others, a gain from either selling or simply owning a property can attract a tax liability. What is more, for the UK-resident owner, rental income or price appreciation can necessitate the rigmarole of seeking relief under complex “double tax relief” provisions. And all these “hidden” taxes come on top of the primary taxes that are incurred when purchasing and owning a home in your chosen destination.

So what are you letting yourself in for?

Here we identify some of the key tax considerations associated with owning property in the most popular destinations. The assumption, throughout, is that the owner is currently a UK-tax resident.



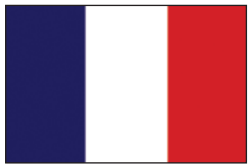
Justin Rix, Senior Manager – Expatriate Tax Specialist

Figure 8: Tax on rental income

| | UK | France | USA | Cyprus | Spain | Portugal | Italy |
|--|-----------|------------|---|--|------------|---|-----------|
| Tax on rental income | Up to 40% | Up to 40% | Up to 30% (+ state taxes if applicable) | Up to 30% (plus defence tax of 3%) | Up to 25% | non resident withholding rate 15% | Up to 43% |
| Wealth tax (on value of property owned) | None | Up to 1.8% | None | None | Up to 2.5% | None | None |

Source: Grant Thornton

France



Buying the property

Stamp duty has been abolished in France.

On the purchase of a property, a registration duty of 5.19% applies. This rate can be reduced by local authorities to as low as 2.59%.

Owning the property

For non-French tax residents, wealth tax is levied on property in France. This applies where the aggregate net value of property owned by the family unit in France exceeds €760,000 (2007 band). The rate is determined by the value of the property and can range from 0.55% to 1.8%.

There are several taxes that are equivalent to UK council tax for individuals.

- Taxe d'habitation: assessed on the rental value of the property. Rates vary from 2.19% to 11.74%.
- Tax on developed land: assessed on 50% of the rental value of the property. Rates vary from 1.07% to 4.8%.

- Tax on undeveloped land: assessed on 80% of the rental value of the property. Rates vary between 0.9% and 12.84%.
- Taxe d'enlèvement des ordures ménagères (tax on domestic garbage collection) assessed on 50% of the rental value of the property.

The rental value is set by the land registry but is not updated regularly.

Each of the taxes described above is set by the local municipality in order to meet its own budget requirements. Each local government can independently determine the tax percentage that it sets, therefore tax rates may vary significantly from one municipality to another one, with different tax exemptions.

Selling the property

Capital gains on immovable property are subject to a 16% flat tax rate for EU residents, plus 11% in specific social contributions.

The capital gain is calculated by deducting the costs of acquiring the property, along with any expenditure incurred for works and repairs to improve the property, from the sales proceeds. Taxable gains on real estate are calculated according to the duration of ownership by applying a 10% yearly

rebate after the fifth year. The remaining amount is taxed at the 16% flat rate. Because of the annual 10% rebate, capital gains realised more than 15 years after acquiring the property are free of income tax.

Certain capital gains are expressly exempt, such as those derived from the sale of the taxpayer's main home (résidence principale) or on the sale of a building whose price does not exceed €15,000.

Specific computation rules apply to real estate dealers and a rate of 50% applies on the sale of a property built by a foreign vendor or on the sale of plots for development by non-French residents or by foreign real estate dealers.

Spain



Buying the property

Capital transfer tax is levied at a general rate of 6% (7% in the most autonomous regions) on the second and any subsequent transfer of immovable property and rights to it. This excludes guarantees.

Stamp duty is not always payable when acquiring a property and the rate depends on where the property is located.

Owning the property

Real estate taxes are levied at 0.4% on the cadastral value of the property, as set by the authorities, and at 0.3% on rural property. Town councils are able to increase these rates up to a certain limit.

For non-Spanish tax residents, wealth tax is raised on property situated in Spain. The rate applicable is based on the value of the property and ranges from 0.2% to 2.5%.

Ownership of a residence, other than the primary residence, gives rise to an imputed annual income of 2% of the cadastral value (1.1% where the value was adjusted after 1 January 1994).

If rental income is received on the property, rather than the imputed annual income detailed above, the actual gross rental income will be subject to tax at 25%, assuming the owner of the property is not a Spanish tax resident. No deductions for expenses associated with the rental of the property can be made by non-resident individuals calculating income subject to tax.

Non-resident companies owning real estate in Spain are liable for an annual special tax, based on the value of the property, at a rate of 3%.

Where a special declaration is filed, non-resident companies may be exempt from this tax. This applies where the direct owner is a company resident in a country with which Spain has a tax treaty that includes an exchange of information clause. It also requires that the final owners of the shares are resident in a country, with which a double tax treaty has been signed, containing a provision for the exchange of information.

Selling the property

Capital gains derived by non-residents are generally taxed at 35%. Current reforms to Spanish tax law may see this rate reduced to 18%. Non-residents benefit from reductions based on the length of ownership for properties acquired before 31 December 1994. As part of the reform, it is anticipated that the reduction will only apply to the proportion of capital gain generated since the date of acquisition until 20 January 2006.

In addition, there is an anti-avoidance measure that requires purchasers (individual or corporate) of Spanish immovable property from non-residents owners (individual or corporate) without a permanent establishment in Spain to withhold 5% of the purchase price. If the tax is not withheld, the tax authorities can place a lien on the underlying property in order to collect the tax due. It is expected that this rate will reduce to 3% from 1 January 2007.

Italy



The tax rules concerning immovable property in Italy have recently undergone various changes. Further modifications are anticipated. The tax implications detailed below reflect current legislation.

Buying the property

Registration tax is due on deeds and contracts that are subject to registration in public registers or which are voluntarily registered in such registers. In general, written contracts concluded in Italy for the transfer of property of any kind are subject to registration.

Rates of registration tax vary according to the property transferred. The standard rate on contracts for the transfer of immovable property located in Italy is 7% (rising to 15% for rural land).

Where the property is the main residence (the so called “prima casa”) the rate of registration tax is 3% (instead of 7%).

Further direct taxes arise on purchase: a cadastral and mortgage tax are each levied at 3%. For the “prima casa” there is a fixed charge of €336 (€168 for mortgage tax and €168 for cadastral tax). Mortgage tax is payable even where there is no mortgage on the property.

Owning the property

Italian municipalities put a tax on the provision of services. There include:

- Addizionale Regionale (Regional Increase of Personal Income Tax)
- Addizionale Comunale (Municipal increase of Personal Income Tax)
- ICI (Annual Tax on Building and Real Estate)
- TARSU (Tax on disposal of litter and garbage).

The rates at which these taxes are applied vary by municipality, by the cadastral value and size of the property and by the number of occupants.

ICI is levied on cadastral (imputed) income. The amount of cadastral income is determined by the local Cadastral Office and depends on factors such as location, use and date of construction of the property. In the case of building plots, market value is used instead of cadastral value. The rate of ICI is set by the local authority and varies from 0.4% to 0.7%. ICI is an annual tax, payable in two instalments – on 20 June and 20 December (until the end of 2006) and on 16 June and 16 December (from 2007).

Selling the property

The gain on the transfer of residential property is subject to tax. The difference between sale price and purchase price is normally taxed at the individual's marginal rate of income tax. If the transaction occurs between two individuals, it is possible to opt for a substitute tax (levied at 20%).

There is an exemption from income tax where the property has been owned for five years or was received from a transferor who held it for more than five years.

The US



Buying the property

While each state, city and local municipality in the US has specific real estate laws, no general registration tax is generally imposed on the purchase of property. However, the buyer should expect to incur numerous miscellaneous fees and “taxes” along the way. These could total thousands of dollars for transfer taxes, survey taxes, stamp taxes, title insurance charges, underwriting fees, processing fees, hazard insurance and other items.

Owning the property

Local states, cities and municipalities generally apply real estate tax on property. The rate at which this is applied varies according to the location of the property and, typically, its size and value.

Non-residents owning US real estate are generally taxed at a flat rate of 30% on gross rental income from the property. Non-residents can elect, however, to treat all of their US real estate rental income as effectively connected with a US trade or business.

By making this election, the non-resident can offset gross rental income with expenses incurred in connection with the rental (including travel to inspect and visit the rental property) and to claim a depreciation deduction for the property, its capital improvements and furnishings. Any net rental income is taxed at graduated rates: single rates for a single person and married filing separately rates for married persons.

Rental income paid to a non-resident landlord is generally subject to withholding tax at a rate of 30% of the gross rents. The rent payer is responsible for withholding this amount and paying it over to the US authorities.

The rental income may also be subject to state and local taxes. The rate depends on the state in which the property is located. There are a number of states, eg Florida and Texas, which do not apply state taxes.

Selling the property

Gains realised on the sale of the US property are subject to US capital gains tax. If the property has been held for a period of at least 12 months, any gain on sale will be subject to federal tax at a rate of 15%. State and local taxes may also apply. The purchaser of the property, through the property sales agent, is required to withhold 10% of the purchase price and pay this over to the US authorities.

Where an election is made to treat the property as connected to a US trade or business, and where a depreciation expense has been claimed against rental income received on the property, this depreciation will be “recaptured” and taxed at a 25% flat tax rate.

Cyprus



Buying the property

Cyprus applies transfer tax of between 3% and 8% of the value of the property on transfer of ownership. There are some reliefs and exemptions where, for instance, the transfer takes place between family members.

Owning the property

Annual real estate tax of 0.4% is applied to properties valued at over CYP500,000. This applies to both resident and non-resident property owners. Rental income received in respect of a Cyprus property is subject to income tax up to a maximum rate of 30% (applicable on income over CYP20,000). A deduction, equivalent to 20% of gross rents, is used in calculating the taxable rental income. In addition, rental income is also subject to a defence contribution at a rate of 3% on 75% of the gross rental income.

Selling the property

Gains on the sale of property situated in Cyprus are subject to tax at a rate of 20%. This is calculated after taking into consideration inflation and interest on the mortgage raised to acquire the property. Under certain conditions there is a lifetime exemption of CYP50,000 for properties used as main residence.

Portugal



Buying the property

In Portugal, stamp tax at 0.8% is levied on property purchases.

IMT (Imposto Municipal sobre Transmissões) is a transfer tax. It is payable on a sliding scale of 2% – 6% on all urban properties valued at more than €3,500. A flat rate of 6% applies on properties valued at €21,700 or more, while a flat rate of 5% is levied on rural land.

This tax also applies to beneficiaries or purchasers of 75% or more of the share capital of “Lda.” companies holding real estate. It is calculated according to the rateable value of the real estate.

Owning the property

In Portugal, IMI (Municipal Tax on Real Estate) is the equivalent of UK council tax. Rates vary according to whether or not the property has been revalued under rules introduced at the end of 2003.

For revalued properties, the tax is between 0.2% and 0.5% of the assessed value of the property by the tax authorities. The specific rate is defined by each municipality and the value tends to mirror market value.

For properties that have not been revalued, the tax is between 0.4% and 0.8% of the assessed value of the property (usually the acquisition price). Typically this is below market value.

Rural property attracts a rate of 0.8%.

Where property is used for dwelling or rental purposes, an exemption period is granted. This may vary from three to six years depending on the net worth value of the property (no exemption is granted where the value exceeds €25,000).

For Portuguese personal income tax purposes, non-residents are required to submit an annual return detailing income received from letting a property. For non-residents, income on rental profits is taxed at a flat rate of 15%. No deductions are permitted for tax purposes for mortgage interest against rent for non-residents, although repairs and maintenance expenses are permitted.

Moreover, in case of property owned by blacklisted companies which (i) are not used for rental purposes or (ii) which are not attached to a commercial activity, an amount equal to one-fifteenth of the property's net worth value is deemed as income and is taxed for corporate tax purposes.

Selling the property

Gains realised by non-resident individuals directly (in other words, not through a permanent establishment in Portugal) from the sale of property is subject to IRS at a final tax rate. This final tax is assessed according to the return filed by the non-resident's local representative at a rate of 25% on the gain arising on the sale.

Case study: Overseas property ownership and development

Michele Haddican, Tax Manager at Grant Thornton

Since selling his business in 2002, Mr Pearson¹ has purchased eight properties in Spain using Grant Thornton to identify tax-efficient methods of investment. He made his purchases at a time when the Spanish property market was buoyant and chose properties either close to the sea or by a golf course.

“After I sold my business, I chose to invest in property in order to balance my portfolio,” explains Mr Pearson. “And, because of the British fascination with bricks and mortar, I felt it would be straightforward to sell on those properties once they had appreciated in value – especially with Spain being such a popular country.” Of those eight properties, one is kept as the family residence and six, having grown in value, have been sold. The remaining property is taking longer than anticipated to sell. Mr Pearson puts this down to a saturation of the local market by other property developments and a slower appreciation in value.

“I chose Spain because of its good facilities and easy access via budget airlines.” Mr Pearson has some knowledge of Spanish but because he bought most of his properties ‘off plan’ without visiting them, he used a UK-based estate agent with local contacts.

Mr Pearson recommends getting a good local lawyer to help with the purchasing process. He adds: “Don’t rely on using the lawyer recommended by the developers and avoid deals that involve cash.” He found the process of purchasing property in Spain relatively uncomplicated. The country is so accustomed to non-Spaniards purchasing property in Spain that the local law is now a well-trodden path.



¹ Name changed to protect client’s identity

The Spanish properties were originally bought under a partnership structure which was converted into a company when our client continued to invest in properties. The final property in Spain is owned for personal use so is not owned via the company structure. Mr Pearson has made a will in both the UK and Spain although his principal private residence continues to be in the UK.

Investment opportunities in Montenegro

Mr Pearson has also purchased land in Montenegro. He has been building his portfolio there since 2003, with a long-term view of selling it on to developers. “I am really excited about the prospects in Montenegro. Potentially this could be more financially rewarding than Spain, especially as I entered the market at an early stage. I couldn’t have made the purchases without the help of my business partner who has strong local business knowledge.”

Mr Pearson originally intended to develop villas and apartments on the land but as he has learned more about the Montenegro market, and given the appreciation in land prices, he now intends to sell his plots as undeveloped land. He will continue to acquire new land there.

“I have purchased the land on a peninsular in Montenegro which is surrounded on three sides by the sea. Now I am planning to acquire the land going back to a particular point to make it an attractive investment opportunity for property developers,” he says.

Mr Pearson’s enthusiasm for the Montenegro market has fired up several of his friends with whom he has entered into an agreement. They will start to buy up land on which they will build between 20 and 25 apartments. Mr Pearson comments: “During the process of setting up the agreement with my friends, Grant Thornton’s advice has been invaluable in structuring the new company to minimise my friends’ tax liabilities.”

What to consider before buying a property abroad

- Consider why you want to buy a property abroad.
- Consider where you may want to live long-term.
- Establish your domicile and residency status.
- Take professional advice in your country of residence about your tax position.
- Consider the asset allocation of your estate.
- Check your UK state pension entitlement.
- Secure funding if necessary for the purchase.
- Be aware of potential exposure to currency fluctuations.
- Calculate professional costs of purchasing property (stamp duty).
- Any other costs related to the acquisition (specific to the locality).
- Consider health and life assurance and whether your current arrangements meet your needs.
- Investigate local taxation and seek professional advice (income tax, IHT, capital gains tax, wealth tax, property tax, council tax, and other local taxes on property).
- Check if there is a double tax agreement with your country of residence.
- Make a will in each country where you hold assets.
- Consider your pension funding.

Appendix I

Calculating the number of second homes owned by UK citizens in selected countries

Section 1: Survey of English Housing

The only available data on the number of households owning second homes are contained within the annual Survey of English Housing (SEH) conducted by the Department for Communities and Local Government (DCLG). The survey only questions households that live in England and asks whether they own a second home in England, within Great Britain but not in England or outside Great Britain. Hence this provides considerable problems in estimating the number of UK households owning property outside the UK.

In this survey, the DCLG estimates the number of English households owning a second home outside Great Britain¹. From this figure one must subtract those whose second home is the primary residence of someone else and those who are shortly planning to sell their second home.

Section 2: Removing those households who own second homes in Northern Ireland

The problem with the SEH survey is that it asks people whether they own a second home outside Great Britain. Hence we must estimate those English households owning a second home in Northern Ireland. The process for doing this is outlined as follows:

1. Calculate the number of Northern Irish households living in England (number of people born in Northern Ireland living in England divided by average household size)
2. Calculate the proportion of English households that own a second home (using data from the SEH and Census 2001)
3. Using this proportion, calculate the number of Northern Irish households in England owning second homes
4. We then assume that all those Northern Irish households living in England with a second home are merely Northern Irish residents who own a second home in England.

Using this figure, we can calculate the number of English households owning second homes outside the UK.

Section 3: Including those Scottish, Welsh and Northern Irish households owning second homes outside the UK

Again the SEH does not survey households outside England and hence we need to estimate the number of Scottish, Welsh and Northern Irish households owning second homes outside the UK. The process for this is as follows:

1. For each year, calculate the proportion of English households that have second homes outside the UK (i.e. [number of English households that own second homes outside Great Britain minus number of English households owning second homes in Northern Ireland]/ Total number of English households).
2. We assume that this proportion is weighted for Scotland, Wales and Northern Ireland based on the fact that their average disposable household income is lower than in England.
3. Recalculate the proportion for each country, weighted by a ratio of Gross Disposable Household Income (GDHI) to that of England
4. Multiply the number of households in each country by this weighted proportion to get the number of households in Scotland, Wales and Northern Ireland owning second homes outside the UK

¹ We are forced to ignore those households that own more than one home abroad because this is not recorded within the survey.

We are now in a position to calculate the number of UK households owning second homes abroad. This is simply the figure from the Survey of English Housing minus the figures calculated in Section 2 plus the figures calculated in Section 3.

Figure 9

| Year | Total UK households with second home abroad (000) |
|-------------|--|
| 1995 | 102 |
| 1996 | 131 |
| 1997 | 157 |
| 1998 | 138 |
| 1999 | 131 |
| 2000 | 149 |
| 2001 | 158 |
| 2002 | 179 |
| 2003 | 177 |
| 2004 | 204 |
| 2005 | 280 |

Source: Lombard Street Research

Section 4: Estimating where UK households own second homes

The SEH also provides data on where individuals have second homes.

However this data is only available for 2003/4 and 2004/5. Hence we are forced to assume that the proportions calculated from the 2003/4 survey are representative of previous years. Hence we can estimate the number of second homes owned in certain countries by UK citizens.

Appendix II

Calculating the number of British Nationals living abroad

Section 1: Number of UK state pensions being claimed abroad

Data could not be found on the number of homes owned abroad by British nationals. We found however that an acceptable proxy was the number of British state pensions being claimed by those living abroad. The Department for Work and Pensions (DWP) keeps time series data on this going back to 1995. This is not, however, without its own problems. For it includes all state pensions being claimed abroad. Thus it over estimates the number of British nationals living abroad because migrant workers who worked in the UK and accrued some pension benefits are also included.

Section 2: Removing non-British nationals from the figures

The DWP also keeps data on the value of pensions being claimed from certain countries as a percentage of the total state pension. To receive a full state pension from the UK government, an individual must have worked 44 years. For each year of work, an individual is therefore entitled to 1/44th of the basic state pension. Using the assumption that British nationals are likely to have spent at least ten years working in the UK, while migrant workers probably have not, we suggest that all those claiming pensions worth less than 25% of the basic state pension are local migrant workers who have worked in Britain and returned home. It follows that all those claiming pensions in excess of 25% are British nationals. From this information, one can construct a data series for selected countries of the number of British nationals living abroad².

It is worth mentioning an important caveat at this point: this data ignores those British nationals living abroad who have yet to reach pensionable age. Hence our figures are likely to underestimate the true population living abroad. In light of the evidence that moving abroad is being seen as a lifestyle change for many middle-aged families, this underestimation may be significant.

² This particular data only exists for 2000-2005 so to calculate the caseloads for 1995-2000, we merely use 2000 proportions to generate values for the number of British nationals in the earlier years.

Appendix III

Calculating the total value of UK homes abroad

Section 1: Average dwelling prices

In an ideal world, we would have data on the price of UK homes abroad.

Unfortunately that data is not available so we must make do with an imperfect proxy. In order to calculate the value of UK property abroad, we assume that individuals buy average-priced new dwellings. This is the approach taken by the Office for National Statistics (ONS); however it only constructs price time series for France, Spain and the US. Our approach is more precise in that we were able to construct time series for several more countries and, consequently, have produced more accurate estimates. There may, however, be some question about the use of average house price data: evidence suggests that second-home owners are middle to high earners. Hence there might be a case to suggest they buy above average value homes. Furthermore, especially in France and Spain, second homes tend to be purchased in holiday resorts where house prices might be above the national average. Alternatively, one might argue that since a lot of these second homes are merely holiday homes and hence used infrequently, they may well be below average price. In any event, using average data seems a sensible way forward.

Data on average dwelling prices mainly comes from national data sources. Some, however, is to be found in the publication, EU Housing Statistics 2004. Having constructed time series of average dwelling prices in local currencies, one must convert them to Sterling. This is done by using an annual average of the respective exchange rate.

The above method was used to generate average dwelling price time series data for France, Spain, Italy, Portugal and the US. However generating such data for “Other Europe” and “Rest of the World” was more problematic. For the Rest of World, because of a lack of house price data, we assumed that second homes were only owned in Canada, Australia and New Zealand. Furthermore we assumed that home ownership was equally split between these countries. With average dwelling prices in local currencies for each country, one can simply extract a composite house price measure in Sterling by a simple average.

Generating a house price series for “Other Europe” requires some simplifying assumptions. Due to data limitations, it was not possible to calculate a totally satisfactory measure. For instance, it would be useful to include house price data on many of the Eastern European countries in which UK households now choose to buy. As a proxy, albeit an imperfect proxy, one must calculate an average Europe dwelling price for 2003 using data from the EU Housing Statistics 2004, excluding those countries entered separately in the data. In order to generate a time series, one is forced to resort to the only Europe-wide house price index measure published by the ECB. Of course, this is imperfect because this does include France, Spain, Italy and Portugal which, ideally, would be omitted from the price index. From this one can generate a time series for average dwelling prices for the Euro area, which we use as a proxy for “Other Europe” in our data set.

Section 2: Total value of UK second homes abroad

To calculate the total value of UK homes abroad, one must simply multiply the average dwelling price for each year by the estimated number of homes owned by UK nationals abroad. The latter is clearly the sum of second homes owned by UK residents and those primary residences of UK expatriates. For the first figure, we must turn to the SEH. By multiplying the number of second homes owned by UK residents in a particular country by an average house price measure, we get an estimate of total value of UK nationals' second homes abroad. UK investment in foreign residential property in any year is merely the difference between two successive values. However it must be noted that to be completely accurate, total investment also includes those buying homes with the intention of emigrating in that year. To complete the picture, we need to estimate the value of British expatriates' property abroad.

Section 3: Total value of British national households abroad

We again assume that average dwelling prices are an acceptable estimate of the buying price of foreign homes. For those countries, for which we have complete average house price data³, the total value of British nationals' property abroad is merely the average house price multiplied by the estimated number of British expatriate households in that country. However, the data provided by the DWP merely tells us how many individuals are claiming pensions abroad. Thus we need to make some assumptions as to how many households this corresponds to, so that it is in line with the data from the SEH. Since the evidence suggests that most British nationals living abroad do not have dependents and that it is far more common for couples rather than those living alone to move abroad, we assume that the average household size is 1.8. This is reached by assuming that 80% of British national households are couples without dependents and 20% are those living alone. We assume that household size has remained constant over our sample time-frame. From this, we can calculate the number of British national households abroad from 1995 to 2004.

There is another caveat worth pointing out here: in all this, we are implicitly assuming that all British national households abroad own the property in which they live. We ignore the possibility that British nationals choose to rent property, which seems a fair assumption given anecdotal evidence.

For the remaining countries, which include Greece, Cyprus, the Caribbean and other European countries, we merely use the average Euro-area house price data to calculate the value of British national property in those countries. Clearly this is not a wholly satisfactory method but given the data limitations and the fact that they represent only a small proportion of the expatriate population, it should not affect the overall results.

Section 4: Total value of UK property abroad

Summing these two series together, we can reach an estimate of the size of the UK stock of property abroad. This clearly includes current UK residents with second homes abroad and British expatriates who have moved abroad permanently.

Figure 10

| Year | Total value of UK property abroad (£ billion) |
|------|---|
| 1996 | 27.25 |
| 1997 | 30.75 |
| 1998 | 28.92 |
| 1999 | 29.36 |
| 2000 | 31.89 |
| 2001 | 35.93 |
| 2002 | 41.57 |
| 2003 | 44.52 |
| 2004 | 55.18 |
| 2005 | 70.67 |

Source: Lombard Street Research

³ The countries are France, Spain, Italy, Portugal, Ireland, US, Australia, Canada, New Zealand and South Africa. These countries account for 75% of the British nationals living abroad.

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Lombard Street Research

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