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Legal update —— January 2018

Tax
Inward Investment into UK commercial real estate – overview of UK tax issues

Background

There are various UK tax issues to consider when acquiring UK commercial (i.e. non-residential) real estate as an investment.

Example transaction

A group of non-UK resident investors (the Investors) wishes to buy a tenanted UK commercial property (the Property) as a long term investment (at least 5 years). The purchase price of the Property is £15 million, funded as to £9 million by a commercial UK bank loan at 4% interest (the Bank Loan) and the remaining £6 million by the Investors at 6% interest.

Purchase structure

The purchase structure described below is based on current UK tax legislation. However, the structure will need to be reviewed in light of the proposals announced by the UK government in the autumn Budget 2017 (see "Proposals for change" below). In particular, the question of whether to use a UK company purchaser will need to be considered. It is ultimately a number crunching exercise, but other priorities also apply, for example limited liability, confidentiality and local succession issues.

It is common for the purchaser to be a company which is tax resident in a low tax jurisdiction such as Jersey, Guernsey or the Isle of Man (the Purchaser). There would be a separate Purchaser for each property purchase.

It would be normal for the Purchaser to be owned by another non-UK resident company (Hold Co), perhaps also resident in Jersey etc.

Having such a structure can have advantages in the future. For example, on sale of the Property it would be possible for Hold Co to sell the shares in the Purchaser, thus eliminating a Stamp Duty Land Tax (SDLT) cost for the purchaser (although see below under "Proposals for change").

Funding the Purchaser

As mentioned above, the Purchaser will borrow £9 million via the Bank Loan.

The remaining £6 million could be funded by:

- equity in the Purchaser provided by Hold Co; or
- a mixture of equity (as above) and a loan by Hold Co (the Hold Co Loan), on arm's length terms

A Hold Co Loan would be the most UK tax efficient method. This is because interest on the loan - unlike a return on equity - would normally be deductible from the rents for UK income tax purposes (although see below under "Proposals for change").

UK tax on rental income

The Purchaser will be liable to UK basic rate income tax (currently 20%) on the rental profits (although see below under "Proposals for change").

The Bank Loan

Provided the Bank Loan is for the purpose of buying the Property, the Purchaser should be able to deduct the interest payments when calculating the UK income tax on its rental profits.

The Hold Co Loan

The Purchaser should also be able to deduct the interest payments to Hold Co, provided the Hold Co Loan is:

- for the purpose of buying the Property; and
- on arm's length terms. UK "transfer pricing" advice should be sought to confirm that the terms of the Hold Co Loan can be considered to be arm's length terms.

Restriction of deduction of interest costs

As from 1 April 2017, there is a restriction on deductions for interest payments by large companies. Essentially, the deduction for net UK interest costs is limited to 30% of the group's UK taxable Earnings

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Before Interest, Taxes, Depreciation, and Amortization (known as "EBITDA"), or a percentage under the "group ratio" rule". However, this does not apply to groups of companies with a net UK interest expense of below £2 million.

Anti-avoidance rules have been introduced to counter certain cross-border finance structures known as "hybrid mismatch arrangements". These changes should have no impact on conventional bank debt located in taxpaying jurisdictions, but bank/shareholder debt in no/low tax jurisdictions may be at risk.

Public benefit infrastructure exemption – note that an exemption from the rules is available for real estate investments which have an expected economic life of more than 10 years and which are let to unconnected third parties under leases of less than 50 years, but only in relation to non-recourse loans from unconnected third parties.

Although these restrictions currently apply only to corporation tax, they will apply to inward investment in UK real estate when the income of offshore companies is brought into the corporation tax net as from April 2020 (see below under "Proposals for change").

Withholding tax - rent

Tenants of a UK property (or the managing agent of that property) are required to withhold income tax at 20% on payments of rent to non-resident landlords (such as the Purchaser). This deduction is paid over to HM Revenue & Customs (HMRC, the UK taxing authority) and set against the landlord's ultimate UK income tax liability on the rent (with any over deduction being repaid).

However, the Purchaser can apply to HMRC to receive gross rent i.e. free from withholding tax.

Withholding tax - interest

In certain circumstances there is a withholding tax at 20% on the payment of interest to a non-UK resident lender (e.g. Hold Co).

The Bank Loan

If the commercial lender is a UK bank or the UK branch of an overseas bank, there will be no withholding tax. On the other hand, if the Purchaser borrows direct from an overseas bank then it is likely that a withholding tax issue will arise.

The Hold Co Loan

The Purchaser will be required to withhold tax on the payment of interest to Hold Co unless:

- the interest payable is not UK source interest. A review of the terms of the Hold Co Loan will be required in this regard; or
- Hold Co is tax resident in a jurisdiction with a double tax treaty with the UK which reduces the rate of withholding on UK source interest to nil.

UK tax on interest payments to Hold Co

Assuming Hold Co is not UK resident, then it will have no liability to UK tax on the interest from the Purchaser beyond any amounts which the Purchaser is required to withhold, as mentioned above.

Hold Co may be liable to tax on the receipt of interest in the jurisdiction in which it is tax resident.

SDLT

SDLT will be payable by the Purchaser at the following rates based on the purchase price (including VAT, if any) for the Property.

Slice of the price	Total SDLT cost
Up to £150,000	0%
£150,001+	2% between £150,001 and £250,000 (£2,500)
£250,001+	£2,500 plus 5% on £250,001+

VAT

The issue here is whether the Purchaser will be required to pay VAT (currently at 20%) in addition to the purchase price for the Property. It would be better to pay no VAT since this will reduce the SDLT cost for the Purchaser (see above).

If the Property is tenanted when purchased, it would be unusual for VAT to be payable.

To enable the Purchaser to recover all VAT paid on the costs in relation to the Property, including VAT on the purchase price (if relevant), the Purchaser will need to register for VAT and opt to charge VAT in addition to the rent payable by tenants.

Sale of the Property

Provided the Purchaser is and remains non-UK tax resident throughout, the Purchaser should not be liable to UK tax on any gain or profit when the Property is sold (although see below under "Proposals for change").

Briefly, in order to remain non-UK tax resident, the central management and control of the Purchaser must be exercised outside the UK.

An alternative method of sale could be for Hold Co to sell its shares in the Purchaser.

As mentioned above, this would eliminate the purchaser's liability to SDLT. Provided Hold Co is and remains non-UK tax resident throughout, Hold Co should not be liable to UK tax on any gain or profit on sale of its shares in the Purchaser (although see below under "Proposals for change").

Proposals for change

In the autumn Budget 2017, the government announced a number of major changes to the taxation of inward investment into UK real estate.

Income and gains from residential and commercial

The government proposes to bring into charge to corporation tax as from April 2020 the income of offshore corporate commercial real estate investors (replacing the current income tax charge). Therefore, in time, there will be no tax differential on income between offshore/onshore companies.

One of the results of the above is that UK loan interest relief for inward investors will be restricted to 30% of the group's UK EBITDA etc (see above under "Restriction of deduction of interest costs").

Gains on disposals of residential and commercial

The government proposes that as from April 2019, the UK will tax gains on direct disposals by non-residents, including by offshore companies, of commercial UK real estate. Gains from indirect disposals of UK real estate by offshore companies will also be subject to tax, for example, the sale of a property owning company by its overseas owner.

Not all indirect disposals are included. The entity has to be "property rich", which means an entity where 75% or more of the gross asset value (ignoring liabilities) derives from UK land. Additionally, the overseas owner (including related parties) has to hold, or have held at some point in the previous five years, at least a 25% interest in the entity (including before April 2019).

Rebasing to April 2019 will apply to existing assets in relation to both direct and indirect disposals.

Offshore companies will be subject to corporation tax on the gains.

UK tax filing – as well as the seller, the government intends to require (in some circumstances) that certain UK advisors involved in an indirect sale should notify HMRC that a disposal has taken place

This will be the first time that gains by inward investors on disposals of commercial real estate have been taxed in the UK.

The above changes may also result in inward investment being undertaken by a UK tax-resident company rather than an overseas company. As ever, it is ultimately a number crunching exercise.

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