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Legal update ——— December 2015

Tax
UK tax roundup for inward investment into UK residential real estate

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The UK tax implications for inward investment into UK residential real estate have undergone unprecedented change during the last few years. It has become even more complex with the latest raft of changes announced in the Autumn Statement 2015.

In this bulletin, we set out the major UK tax implications of inward investment into the UK residential real estate market.

There are seven main UK taxes to bear in mind when investing in UK residential real estate:

- Stamp Duty Land Tax (SDLT)
- Annual Tax on Enveloped Dwellings (ATED)
- ATED-related Capital Gains Tax (ATED-related CGT)
- Non-resident Capital Gains Tax (NRCGT)
- Diverted Profits Tax (DPT)
- Inheritance Tax (IHT)
- Income tax

There are also other UK taxes such as Council Tax, but in this Bulletin we will focus on the above bullet-pointed taxes since they will influence how the investment is structured.

There have been some recent changes relating to the deduction of loan interest payments. We will deal with this as a separate point.

Source: Fotolia

From a UK tax point of view, it's ultimately a number crunching exercise, but other priorities also apply e.g. limited liability, confidentiality and local succession issues

Stamp Duty Land Tax

SDLT is a tax payable on (and at the time of) the purchase of UK real estate, both residential and non-residential. The rates of SDLT for residential real estate range from 0% to 15% depending on the consideration for the purchase of the property (and in some cases the value of the property), as follows:

Property price	Total SDLT cost
£125,000 +	2% between £125,000 and £250,000
£250,000+	£2,500 plus 5% between £250,000 and £925,000
£925,000+	£36,250 plus 10% between £925,000 and £1,500,000
£1,500,000+	£93,750 plus 12% on £1,500,000+

There is also a "special" 15% rate of SDLT for residential real estate, including off-plan purchases, which applies if the consideration is more than £500,000 and the purchaser is a company (or other types of corporate-type vehicles). Note, however, that student accommodation, residential care homes and hotels are not "residential" for this purpose.

The 15% rate applies to the entire purchase price. If the 15% rate does not apply, the rates in the above table apply.

There are reliefs against the 15% rate (in which case the rates in the above table will apply) for some genuine businesses such as property investors, traders and developers – although there is no relief if it is intended that a "non-qualifying individual" will be permitted to occupy the property, such as the owner of the company or members of his family. Even then, the relief can be

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clawed back within three years if the conditions fail to be met.

SDLT and additional homes

It was announced in the Autumn Statement 2015 that higher rates of SDLT will apply to the purchase of additional residential properties (such as second homes and buy-to-let properties) for more than £40,000. The government will publish a consultation document on the policy detail in due course.

The higher rates will be 3% above the current SDLT rates for residential property. Therefore, it is assumed the following SDLT rates will apply on a progressive basis to acquisitions of such residential property:

Slice of purchase price	SDLT on the slice
£0 to £125,000*	3%
£125,001 to £250,000	5%
£250,001 to £925,000	8%
£925,001 to £1.5 million	13%
Over £1.5 million	15%

*Only applies to purchases over £40,000. For purchases at £40,000 or under no SDLT return is required.

The increased rates will not apply to corporate or fund purchasers that make significant investments in residential property. The consultation will consider whether the ownership of more than 15 residential properties is appropriate as a requirement for "significant investment" for these purposes.

So far as inward investors are concerned, it appears the "additional home" requirement will be tied in to principal residence relief (PRR) for CGT purposes. PRR depends on a person living in the property for at least 90 days a year (the "occupancy" test), so it is unlikely that inward investors will obtain PRR. In that case, the higher SDLT rates will apply to non-resident buyers.

Timing – the higher rates will apply to contracts exchanged on or after 26 November 2015 if completion takes place on or after 1 April 2016. Therefore, only pre-25 November 2015 contracts are fully protected, provided, as is usually the case in announcements such as this, such contracts are not varied or assigned.

Annual tax on enveloped dwellings

ATED is an annual tax payable on UK residential real estate in certain circumstances. It applies if the property is owned by a company (or other types of corporate-type vehicles) and varies according to the value of the property at certain points in time. Ownership in a company is commonly known as “enveloping”, hence “ATED”.

Source: Fotolia

Currently, ATED applies to properties worth more than £1 million, although this will reduce to £500,000 from April 2016. Properties are revalued every five years, the current valuation date is April 2012, and so the next date will be April 2017. The initial valuation will be when the property is purchased, but there is a potential revaluation on dealings with the property e.g. grant of a lease.

As from 1 April 2015, the rates of ATED are as follows:

Property value	Annual ATED cost
Over £1 million up to £2 million	£7,000
Over £2 million up to £5 million	£23,350
Over £5 million up to £10 million	£54,450
Over £10 million up to £20 million	£109,050
Over £20 million	£218,200

The rates of tax are index linked to increase each year, but the 2015 rates were increased (over 2014 rates) by more than that. The valuation bands do not increase each year.

For the purposes of ATED, a "residential" property includes partly completed/adapted properties, but excludes certain student accommodation, residential care homes and hotels.

Once again, reliefs against ATED apply. They are virtually the same as for 15% rate of SDLT: the focus is on genuine business use, for example, property rental, development and dealing. Again, there is no relief if an unauthorised person can occupy the property.

ATED Returns must be submitted annually and reliefs must be claimed in the Return, they are not available automatically.

ATED-related Capital Gains Tax

ATED-related CGT applies if and to the extent that the property is within the scope of ATED – in effect the two taxes are paired together.

ATED-related CGT is at 28% of the gain, but only gains accruing from 6 April 2013 are caught.

Tax is payable if the value of the property sold is more than £1 million (reducing to more than £500,000 in April 2016). Where part of the property is sold, ATED-related CGT applies if the value of the part sold plus any other interests in the property that are retained, or were previously owned by the seller in the previous six years (since April 2013) is more than £1 million (reducing to £500,000 in April 2016).

ATED-related CGT takes precedence over the NRCGT charge described below. This is because the rate of ATED-related CGT is potentially higher than the rate of NRCGT.

Non-resident Capital Gains Tax

This is a tax charge on non-UK resident individuals (including trustees etc) and "narrowly held" companies owning UK residential real estate.

NRCGT applies to all UK residential real estate, no matter what value – this is different from other taxes described in this bulletin which are value based. NRCGT also applies to a building that is in the process of being constructed or adapted for use as a dwelling, but does not cover vacant building land. The sale of off-plan contracts is covered.

In common with the 15% rate of SDLT and ATED, certain buildings are excluded from NRCGT, such as purpose-built student accommodation (although street properties for student lets are likely to be caught) and care homes.

There are some limited reliefs from NRCGT, for example private residence relief (see below) and sales by "widely held" companies, but there are no "genuine business" reliefs as for the other taxes discussed. Therefore, for example, a property which is rented out will be caught.

The rate of NRCGT follows the current rates of CGT generally:

- Individuals will pay at 18% or 28% depending on the amount of other UK income in the tax year in question (6 April to 5 April);
- Trustees and personal representatives of estates of non-resident deceased persons will pay at 28%; and
- Companies will pay at 20%.

Individuals will be eligible for an annual exemption, currently £11,100 worth of gains; trustees etc will have half the exemption (for personal representatives this will only apply for disposals in the same tax year as the death or the following two tax years); and companies will not have any exemption.

There will be an inflation allowance for companies but no-one else.

Only gains accruing from 6 April 2015 are caught, although it will be possible to elect for a "straight line" method of calculating the gain i.e. time apportioned as between before and after April 2015, or using the original base cost with no time apportionment (useful if the sale would thereby produce no gain or a loss). It would probably be sensible to obtain a valuation of the property as at April 2015, or at least to record now what condition the property is in and any unusual features, as this will help if it is decided to obtain a valuation later on.

Under the normal CGT regime there is an exemption for the sale of an individual's principal private residence (PRR). A restricted form of PRR will be available under the NRCGT regime.

In broad terms, NRCGT will not apply for a tax year for which an "occupancy test" is met. That is, if the owner, or the owner in combination with his/her non-resident spouse or civil partner (but with no night counting twice), stays overnight at the property at least 90 times during the fiscal year. If the property is owned for only part of a year, then the number of required qualifying stays is proportionally reduced. It will therefore be critical to keep good records.

If PRR is available for some but not for the entire period of ownership since 6 April 2015 then part of the gain made will be exempt from NRCGT.

The potential problem with the "occupancy test" is that if it is met, the owner and/or his/her spouse or civil partner may become UK tax resident!

Reporting and paying NRCGT - the sale will need to be reported on a NRCGT Return and the tax paid within 30 days of the day after the day on which the property is sold. If the owner is already within the UK's self-assessment system for income tax and CGT, although the disposal will need to be reported on a NRCGT Return within the same 30 day period, payment will be made as part of the normal end of year tax arrangements (or there will be an the option to pay at the time of reporting); the disposal must be also be reported on the relevant self-assessment tax return.

All sales must be reported even if there is no NRCGT liability!

Diverted Profits Tax

DPT was introduced earlier this year in response to public concern over companies doing business in the UK but paying little or no tax here because, in broad terms, the UK profits were diverted to low tax jurisdictions by various (legal!) methods.

DPT is charged on companies only (not individuals) at the rate of 25%, which is 5% higher than the current top rate of corporation tax on companies (20%). So it is preferable to pay corporation tax rather than DPT.

The DPT legislation is lengthy and complex, but boils down to a tax charge arising out of arrangements which are tax driven and have no real commercial substance; or which avoid creating a taxable presence in the UK (called a "permanent establishment").

In each case if the result is to reduce UK tax by at least 20% compared to another entity's increase in tax, then DPT applies to the diverted profit. For example, if profits are diverted to a tax haven in which there is no local tax charge, this condition will be met because the UK tax charge has been reduced by 100% (i.e. more than 20%).

Whilst DPT is unlikely to apply to most inward investment situations (medium or long term investment ownership) it will apply to some inward trading (e.g. shorter term buy and sell) situations.

Inheritance Tax

An individual owning UK real estate in his/her own name (including via a nominee) is subject to IHT on that property.

Note that this does not apply to a non-UK domiciled person owning the property via an offshore company. This is a major reason why UK real estate is "enveloped" in such companies.

There is a "nil rate band" for IHT of £325,000, and IHT is payable at 40% on the excess. There is also a special regime applicable to property held in trust.

Introduction of IHT on offshore structures holding UK residential property

It was announced in the summer Budget 2015 that from April 2017 the government intends to bring all ATED-chargeable UK residential property held directly or indirectly by non-domiciled persons into the IHT net. This will catch residential property owned through structures such as an offshore company, trust or

Source: iStock

partnership. The change will apply whether the property is used for private occupation or let to third parties. A consultation document will be published in due course with draft legislation to follow.

These further IHT changes might prompt some owners to "de-envelope" and move into a simpler, more straightforward property ownership structure. Either way, the property in question will fall into the IHT net so the importance of lifetime planning cannot be understated.

Income tax

Income tax is payable on any income from the property, for example rent. An individual owner of the property will pay income tax depending upon their total level of income but with a top rate of 45%, whereas a corporate owner will pay at 20%. Therefore, from an income tax perspective, this may favour owning the property via a corporate vehicle.

Interest payments

In general terms, loan interest payments can be deducted against rents for UK tax purposes, provided the loan is for the purpose of buying the property. The deduction is capped at what an unconnected lender would have charged in interest (called "transfer pricing"). This should not affect ordinary bank borrowing, but for companies the interest rate on shareholder loans (sometimes called "internal debt") will need to be reviewed and compared to the amount an unconnected lender would have lent.

Landlords who are individuals – relief for loan interest

At present, landlords who are individuals can claim relief for loan interest payments at the "marginal rate" of income tax if the loan is used to buy the property or to fund repairs, improvements or alterations to the property. For example, relief for a higher rate tax income tax payer will be given at 40% to the extent there is enough income (i.e. rent) taxable at that rate to absorb the interest payments.

It was announced in the summer Budget 2015 that in future, relief for interest payments will be restricted to the basic rate of income tax (20%). This change will be phased in between 2017/18 and 2020/21. This could significantly affect the post-tax level of rental income. Corporate investors are unaffected.

Interest costs - hybrid mismatch arrangements

The government is consulting on how to implement the OECD's proposals on the taxation of "hybrid" arrangements from January 2017.

Depending on how the law is changed, this could result in a denial of a tax deduction for interest costs which arise from "hybrid mismatch" arrangements. For example, interest may not be deductible by the borrower if it is not taxed in the hands of the lender. 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. Overseas jurisdictions may respond to the OECD proposals by introducing/increasing local tax charges on interest receipts.

A further proposal from the OECD is to limit interest deductions to a fixed percentage of EBITDA (earnings before interest, tax, depreciation and amortisation) somewhere between 10-30%. Subject to how the proposal is implemented, this could restrict interest deductions on both bank debt and connected party debt (such as shareholder loans).

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