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Legal update —— January 2018

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

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

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

- Stamp Duty Land Tax
- Annual Tax on Enveloped Dwellings
- ATED-related Capital Gains Tax
- Non-resident Capital Gains Tax
- Diverted Profits Tax
- Corporation tax
- Income tax
- Inheritance Tax

There are also other UK taxes such as VAT and Council Tax, but in this bulletin we will focus on the above taxes since they will invariably influence how the investment is structured.

From a UK tax point of view, it is ultimately a number crunching exercise, but other priorities also apply, for example limited liability, confidentiality and local succession issues.

Stamp Duty Land Tax (SDLT)

SDLT is a tax payable on (and at the time of) the purchase of UK real estate, residential and non-residential. The tax is calculated by reference to the purchase price (and/or rent) paid for the property.

The rates of SDLT for residential real estate range from 0% to 15% depending on the purchase price of the property (or in some cases the value of the property) and other circumstances.

Normal residential rates

The normal rates of SDLT are as follows:

Property value (freehold)	Total SDLT cost
£0 to £125,000	0%
£125,000+	2% between £125,001 and £250,000
£250,000+	£2,500 plus 5% between £250,001 and £925,000
£925,000+	£36,250 plus 10% between £925,001 and £1,500,000
£1,500,000+	£93,750 plus 12% on £1,500,001+

The 3% SDLT surcharge

There is a 3% SDLT surcharge on the normal rates described above which applies to the purchase of certain residential properties.

In broad terms, the surcharge applies to the purchase of additional residential properties, such as second homes and buy-to-let properties, for more than £40,000; and all properties purchased by companies for more than £40,000.

Therefore, the surcharged rates are as follows:

Property value (freehold)	Total SDLT cost
Up to £125,000	3% i.e. £3,750
£125,000+	£3,750 plus 5% between £125,001 and £250,000
£250,000+	£10,000 plus 8% between £250,001 and £925,000
£925,000+	£64,000 plus 13% between £925,001 and

Published by
Towers & Hamlins

Trowers & Hamlins LLP
3 Bunhill Row
London
EC1Y 8YZ

t +44 (0)20 7423 8000
f +44 (0)20 7423 8001

www.trowers.com

	£1,500,000

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

The surcharge regime is complex, but the main principle is that the surcharge will apply if, at the end of the day on which the property in question is purchased:

- individuals - the price for the new dwelling is £40,000 or more, it is not subject to a lease with more than 21 years to run, and it is not a replacement for the buyer's only or main residence
- Individuals – the buyer owns a dwelling other than the new dwelling which has a market value of £40,000 or more and is not subject to a lease with more than 21 years to run
- companies – applies to all purchases provided the dwelling has a market value of £40,000 or more and is not subject to a lease with more than 21 years to run.

Other highlights of the regime are as follows:

- joint purchasers - the surcharge will apply if any of the purchasers meets the above conditions.
- the 36 month "window" - there is a 36 month timeframe either side of the transaction in question to test if the new dwelling is a replacement for the buyer's only or main residence. For example, this would allow the purchase of the new dwelling to escape the surcharge if the purchaser's only or main residence is sold with that timeframe before or after the purchase in question.
- overseas property - property owned outside the UK is taken into account in testing whether the surcharge will apply.
- inherited property and trusts - inherited and trust property counts, subject to conditions, in testing whether the surcharge will apply.
- Multiple Dwellings Relief (MDR) and the six or more properties rule - in broad terms, MDR applies to portfolio purchases and results in SDLT being applied to the average price per dwelling. Under the 6 or more properties rule, the purchase of 6 or more residential properties at the same time is treated as a commercial (i.e. non-residential) transaction for SDLT purposes. For purchases of 6 or more properties, the purchaser will be able to choose between MDR (with the surcharge applying to the average price) and the commercial rates.

The 15% rate of SDLT

There is also a "special" 15% rate of SDLT for residential real estate, including off-plan purchases, which applies if the purchase price is more than £500,000 and the purchaser is a company (or other type of corporate vehicle). If this rate applies, the surcharge mentioned above does not apply.

Note 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 tables apply (including the surcharge).

There are reliefs against the 15% rate (in which case the rates in the above tables will apply, including the surcharge) 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 clawed back within three years if the conditions fail to be met.

Annual tax on enveloped dwellings (ATED)

ATED is an annual tax payable on UK residential real estate in certain circumstances.

ATED applies if the property is owned by a company (or other type of corporate vehicle) 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".

ATED applies to properties worth more than £500,000. Properties are revalued every five years, the current valuation date is April 2017, and so the next date will be April 2022.

The initial valuation will be when the property is purchased (if after April 2017), but there is a potential revaluation on dealings with the property e.g. grant of a lease.

The current rates of ATED are as follows:

Value of the property on the relevant day	Annual ATED cost
£500,000 to £1 million	£3,600
£1 million+ to £2 million	£7,250
£2 million+ to £5 million	£24,250
£5 million+ to £10 million	£56,550
£10 million+ to £20 million	£113,400
£20 million+	£226,950

The rates of tax are index linked annually, with the last update occurring on April 2017 for the April 2017/18 chargeable period.

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

There are a number of reliefs against ATED. 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)

ATED-related CGT applies to a capital profit on sale of the property if and to the extent that the property is within the scope of ATED - in effect the two taxes are paired together. It is often the case that if and to the extent that ATED does not apply, NRCGT will apply to the gain in question (see below).

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 £500,000.

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 £500,000.

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 (NRCGT)

NRCGT is a tax charge on non-UK resident individuals (including trustees etc) and "narrowly held" companies owning UK residential real estate. Note that the exclusion for companies which are "widely held" will be removed as from April 2019 (see below under "Proposals for change").

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 described above.

Therefore, for example, a property which is rented out will be caught.

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

- individuals will pay at 18% or 28% (or a combination of both) depending on the amount of other UK income and gains 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%

Companies will pay at NRCGT at 20%.

Individuals will be eligible for an annual exemption, currently £11,100 worth of gains (insofar as not utilised against other 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 (until 1 January 2018 under current government proposals) 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, called private residence relief (PRR), for the sale of an individual's main residence. An amended form of PRR is 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, stays overnight at the property at least 90 times during the fiscal year (but with no night counting twice). 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)

DPT was introduced in response to public concern over multi-national 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 6% higher than the current top rate of corporation tax on companies (19%). 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 an entity in 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 investments) it will apply to some inward trading (e.g. shorter term buy and sell) situations.

Corporation tax and property trading in the UK

Legislation was introduced in 2016 to capture profits from trading in and developing UK land, notwithstanding the person undertaking the activity is non-UK tax resident.

The rules apply equally to residential and commercial property, and to corporates and individuals.

In broad terms, the new rules are designed to close some perceived gaps in the then legislation, in particular around whether or not land trading/development creates a "permanent establishment" in the UK to which a UK tax liability can attach. Therefore, the new rules create a UK tax charge on profits from dealing in or developing UK land regardless of the tax residence status of the landowner or whether or not the activity is conducted through a permanent establishment in the UK.

According to HM Revenue & Customs (HMRC, the UK taxing authority), the majority of the UK's international double taxation agreements (DTAs) need not be amended to allow for these changes; however, a small number of older DTAs will require some changes "to put the position beyond doubt". Already, the DTAs with Guernsey, the Isle of Man and Jersey have been amended.

The new rules will also "look through" "enveloping" the profits in a single purpose corporate vehicle to enable a disposal of the property by way of a share sale rather than the underlying property.

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 an offshore corporate owner will pay at the basic rate of 20%.

Therefore, from an income tax perspective, this may favour owning the property via a corporate vehicle.

Interest payments - general

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

Until 5 April 2017, landlords who are individuals could 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.

However, from 6 April 2017, and with further phasing in until the 2020/21 tax year, the deduction from property income is restricted to 75% of loan interest payments, with the remaining 25% being converted into a tax credit at the basic rate. In the tax year 2020/21, the entire loan interest payments will have been converted into a basic rate tax credit. This could significantly affect the post-tax level of rental income. Corporate investors are unaffected.

Landlords who are companies

As from 1 April 2017, there is a restriction on deductions for interest payments by large companies (although net UK interest of less than £2 million is allowable). Essentially, the deduction for net UK interest costs is limited to 30% of the group's UK taxable Earnings Before Interest, Taxes, Depreciation, and Amortization (known as "EBITDA"), or a percentage under the "group ratio" rule".

Additionally, there are anti-avoidance rules 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.

Inward investment into UK real estate may be vulnerable to these proposals since the investments are often highly geared. Furthermore, there are no "grandfathering" provisions, so even existing structures will be caught.

Although these restrictions apply only to corporation tax payers (not income tax payers), they will apply to inward investment in UK investment property when the income of offshore companies is brought into the corporation tax net as from April 2020 (see below under "Proposals for change").

Inheritance Tax (IHT)

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

Note that until April 2017, IHT did not apply to a non-UK domiciled individual owning the property via an offshore company. Historically, this was a major driver for UK real estate being "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 – as from 6 April 2017, shares in a closely held offshore company owned by a non-UK domiciled individual and holding UK residential property are now subject to IHT to the extent that the value of the shares derives from that property. Any interest in the company is ignored where its value is less than 5% of the total value of the interests in that company. Certain loans provided to acquire or maintain UK residential property will also be liable to IHT, plus the value of security, collateral or guarantee for such loans (which creates a potential double charge to IHT).

This will catch residential property owned through structures such as an offshore company, trust or partnership, and will apply whether the property is used for private occupation or let to third parties.

These IHT changes might prompt some owners to "de-envelope" and move into a simpler, more straightforward direct property ownership structure.

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 the following into charge to corporation tax as from April 2020 for corporate investors:

- the income of offshore real estate investors, both residential and commercial (replacing the current income tax charge). Therefore, in time, there will be no tax differential on income between offshore/onshore companies
- gains on disposal of residential currently subject to NRCGT (e.g. disposals by close 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 "Income tax").

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 residential and 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, and the government is seeking views on whether ATED-related CGT should survive these changes.

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.

For more information please contact

Abdul-Haq Mohammed
Partner
t +973 1751 5607
e amohammed@trowers.com

Nick Green
Partner
t +973 1751 5604
e ngreen@trowers.com

Bill Jefferies
Partner
t +971 4 302 5120
e bjefferies@trowers.com

Youssef Boulos
Partner
t +971 2 410 7616
e yboulos@trowers.com

Alastair Glover
Partner
t +971 4 302 5101
e aglover@trowers.com