Corporate, Finance and Investments

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Investment in UK commercial real estate by UK Non-residents – Overview of the main UK taxes and tax implications of latest developments

BACKGROUND

Changes to the UK tax treatment of non-UK residents means that gains arising from direct and indirect disposals of UK commercial real estate by non-UK residents are subject to capital gains tax in the UK (with effect from 1 April 2019) and the UK corporate tax (rather than income tax) regime will apply to the UK property businesses of non-UK resident corporates (with effect from 1 April 2020).

This note provides an overview of the main UK taxes applicable to non-residents acquiring, owning and disposing of UK commercial real estate, and highlights the implications of some of the recent changes in UK tax law impacting non-UK residents.

OVERVIEW OF UK TAX POSITION

	Tax	Rate	Points to note
1	Corporation tax on capital gains (for corporates)	19%, reducing to 17%, with effect from 1 April 2020	Disposals of 'property rich vehicles' are also subject to the tax charge, and there are specific rules in respect of collective investment vehicles – see below.
2	Non-residents capital gains tax (for non-corporates and certain trusts)	Up to 20%	
3	Withholding tax on finance payments where finance used to acquire UK real estate	20%	The charge applies where the payment is 'UK Source income'. This will depend on a number of factors discussed below.
4	Stamp Duty Land Tax ("**SDLT**") on acquisition of commercial real estate	£2,000 on first £250,000 and 5% of value above £250,000	
5	VAT on acquisition	20%	Relief is available where the acquisition is a 'transfer of a going concern'.
6	Withholding tax on rents paid to non-UK residents	20%	Relief is available under the 'UK Non-Resident Landlord Scheme'.
7	Income tax on profits of UK property business	20%	This is applicable for non-UK tax resident corporations until 1 April 2020, thereafter corporation tax will apply.
8	Corporation tax on profits of UK property business	17%	This will apply to non-UK tax resident corporations from 1 April 2020.
9	VAT on rents	20% (**output tax**),	Applicable if election made to charge VAT on the real estate.
10	VAT on UK fees and expenses	20% (**input tax**)	VAT input tax on UK supplies and services received in respect of a UK property business may be set-off against VAT output tax on rents.

UK TAX ON INCOME FROM UK REAL ESTATE

Income receivable by a non-UK tax resident from UK real estate is currently liable to UK income tax (at 20%). With effect from 1 April 2020, non-UK tax resident companies will instead become subject to UK corporation tax on the profits arising from a UK property business (at 17%). As well as different rates of tax, the UK corporation tax regime is governed by different UK tax legislation, including in relation to the deductibility of interest (see below).

UK INTEREST DEDUCTIBILITY

Income tax

Interest incurred by a UK property business will generally be deductible for UK income tax purposes provided that the loan facility complies with the UK transfer pricing rules (i.e. the terms of the facility are arm's length in terms of amount of loan and rate of interest) and the facility is used wholly and exclusively for the purposes of the UK property business. Shari'ah compliant financing structures meeting the conditions of the UK Alternative Finance regime (**Alternative Finance Arrangements**) are also treated as loans for these purposes, with the 'alternative finance return' being treated as interest.

Corporation tax

The interest deductibility rules for corporation tax are potentially more complex. In addition to compliance with the UK transfer pricing rules and the wholly and exclusively test, the deductibility of interest and alternative finance return payments for corporation tax purposes are subject to the UK 'anti-hybrid' rules and the UK corporate interest restriction (**CIR**).

Anti-Hybrid Rules

The UK 'anti-hybrid' rules apply where an amount is deductible, for corporation tax purposes, without a corresponding amount of taxable income arising to another person, or where the amount is also deductible from another person's income for tax purposes.

These rules can restrict the amount of interest which is deductible in respect of a UK property business. Detailed analysis of the tax regime applying at each level of the holding structure will normally be required in order to assess the potential impact.

CIR Rules

The UK CIR rules limit the amount of interest that can be deducted by a 'group', as a whole, to the lower of 30% of a group's 'EBITDA' (corporation tax profits and losses, excluding tax, interest and certain tax reliefs) and the total net external interest of the group. However, this is subject to a £2 million annual interest 'de minimis' threshold per group and to the application of the 'Public Infrastucture Exemption' (**PIE**) which may reduce the impact of the CIR by exempting certain types of third-party interest from the restriction.

A 'group' for these purposes is the parent and its consolidated subsidiaries for accounting purposes. As a consequence, where investment entities are consolidated within the same group, they will not each have the benefit of the £2 million exemption.

As well as interest and alternative finance returns, the CIR applies to payments under derivatives contracts, finance leases, debt factoring and other financing arrangements.

The CIR is applied after any other restrictions on interest deductibility are taken into account, for example, as a result of the application of the UK transfer pricing and anti-hybrid rules mentioned above.

'Public Infrastructure Exemption'

The PIE applies to companies which are carrying on a UK property business where the buildings used for the UK property business are let on a short term basis (i.e. less than 50 years), and where all or all but an insignificant proportion of the company's income for an accounting period derives from carrying out qualifying infrastructure activities (which includes the acquisition, improvement and operation of buildings which are used for a UK property business).

UK WITHHOLDING TAX (WHT) ON INTEREST

A borrower is required to deduct UK withholding tax at 20% from payments of 'yearly interest' which are 'UK source' income, unless (i) an exemption applies (for example the interest is paid to a UK Bank or the loan is structured as a quoted Eurobond), or (ii) the lender (where not tax resident in the UK) can rely on relief under a Double Taxation Treaty. This requirement also applies to alternative finance returns paid under Alternative Finance Arrangements.

Interest will be 'yearly interest' if the loan extends, or is intended, or possible, for the loan to extend beyond a period of one year.

The question of what amounts to 'UK source' income is subject to UK case law. The case law assesses the overall structure of the financing and considers the extent to which the arrangements reference the UK (such as the debt being secured on UK real estate or other UK assets, the agreement being governed by English law, the borrower owning UK real estate/assets, or one or both of the borrower and lender being UK tax resident and/or incorporated).

Where the finance arrangements contain material referencing to the UK, it is likely that interest payments would be considered UK source income and, therefore, that UK WHT is applicable.

The most recent case law[1] suggests that financing arrangements will have a UK source where, in addition to other 'UK factors' being present, all returns paid to the lender are derived, ultimately, from the holding of UK assets.

TAXES ON EXIT

UK tax is payable on capital gains arising from the disposal of UK real estate by non-UK residents (a **direct disposal**) and from the disposal of an interest in a 'UK property rich' entity (an **indirect disposal**).

Companies are liable to tax at the corporation tax rate (currently 19%, reducing to 17% from 1 April 2020) and non-corporates are charged capital gains tax at rates up to 20% on commercial real estate.

An entity is 'UK property rich' where 75% or more of the gross asset value of the entity is derived from UK property.

Indirect disposals

Where a UK property rich entity is **not** a 'collective investment vehicle' (**CIV**), a UK tax charge on capital gains will only arise on an indirect disposal where the seller has a 'substantial indirect interest' in the real estate owned by the UK property rich entity. Other exemptions may also apply, for example, the 'substantial shareholding exemption' (**SSE**) (see below), or if the seller is a sovereign immune entity or an overseas pension scheme.

A person has a 'substantial indirect interest' in real estate if they have held a 25% investment in the entity or entities owning the real estate at any time in the 2 years prior to the disposal.

Where a UK property rich entity is a CIV a UK tax charge on capital gains will arise on an indirect disposal even where the shareholder does not have a substantial indirect interest.

A CIV is defined as a collective investment scheme, an alternative investment fund or a REIT.

Elections for CIVs

A UK property rich CIV may be able to make one of two elections: a transparency election or an exemption election in order to ensure that double taxation and/or indirect taxation of exempt investors in the fund structure can be avoided.

The transparency election

[1] See Ardmore Construction Ltd v Revenue and Customs Commissioners [2018] EWCA Civ 1438, 21 June 2018

A UK property rich CIV which is transparent for income purposes can elect to be transparent for capital gains purposes as well. This election is not relevant to CIVs constituted as partnerships, as they will already be transparent for the purposes of capital gains. This election is irrevocable.

Where the election is made, it will be as if each investor in the CIV held the real estate directly (or, technically, in partnership with the other investors). When the real estate is sold, the investor is treated as selling the underlying property (or its share of the property).

This enables investors who are tax exempt to claim their exemption and means that investors who are not tax exempt should be subject to tax on capital gains from the real estate only once.

The exemption election

A UK property rich CIV which meets certain conditions can elect to be treated as exempt from tax on UK capital gains. Where this election is made, the fund vehicle itself will be exempt from tax on direct or indirect disposals of UK real estate. A proportion of gains realised on a direct or indirect disposal by an entity in which the fund vehicle has at least a 40% investment will also be exempt from tax.

The election ensures that there is no double tax charge within the fund structure, but that the investors will be subject to tax on gains arising from disposals of interests in the fund itself, unless they are also exempt.

The SSE

Subject to certain conditions, the SSE exempts the sale of shares in a UK property rich company from tax where the ultimate owners are 'qualifying institutional investors' (**QIIs**). QIIs include UK and overseas pension schemes, life assurance businesses, sovereign wealth funds and sovereign immune entities, charities, investment trusts, UK authorised investment funds and certain unauthorised unit trusts.

UK Double Tax Treaties

UK Double Tax Treaties (**DTT**) with certain jurisdictions prevent the UK from taxing capital gains arising on indirect disposals of UK real estate. The disposal of an interest in a UK property rich entity by a tax resident (investor or intermediate holding vehicle) of one of these jurisdictions is, therefore, not currently subject to a UK tax charge on any capital gain.

DTT relief may be available for holding vehicles or investors tax resident in other jurisdictions who are subject to tax in the UK on a direct or indirect disposal of UK real estate.