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Client Alert

Corporate, Finance and Investments

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Capital Gains Tax (CGT) payable by non-UK resident investors on direct and indirect disposals of UK commercial real estate

Non-UK resident investors (**Investor**) usually acquire UK commercial real estate (**UK Property**) through non-UK resident companies, for example Jersey limited liability companies. A typical holding structure put in place by an Investor to acquire UK Property involves such Investor establishing a Jersey holding company (**Holdco**), Holdco establishing a Jersey property company (**Propco**) and Propco acquiring the UK Property.

In our November 6, 2019 Client Alert we noted that with effect from 6 April 2019, UK tax is payable on capital gains arising from the disposal of UK Property (a **Direct Disposal**) and from the disposal of an interest in "UK property rich" entities (an **Indirect Disposal**) by non-UK residents who hold a substantial indirect interest in the UK real estate (generally, at least 25%). An entity is "UK property rich" where at least 25% of the market value of the gross assets of the entity is derived from UK real estate.

Where UK commercial real estate is disposed of for the first time since 6 April 2019, the seller (whether via a Direct Sale or an Indirect Sale) has the option to calculate the chargeable gain using either the "historic cost method" or the "market value method".

If the historic cost method is used, in general terms, the chargeable gain is the difference between the original acquisition cost of the UK Property and the disposal price.

If the market value method is used, in general terms, the chargeable gain is calculated on the difference between the market value of the UK Property on 5 April 2019 and the disposal price.

The valuation method chosen will depend on whether the value of the UK Property on 5 April 2019 is greater or less than the original acquisition cost. In the case of an Indirect Disposal, however, any loss resulting from use of the original acquisition cost will not be available to reduce profits for tax purposes.

You may think that the 5 April 2019 valuation is always going to be higher than the original acquisition cost (and therefore you would always use the current value method to calculate the chargeable gain), but that is not always the case.

Taking an example:

- Fully tenanted UK Property is acquired on 31 March 2014 for £30,000,000.
- The tenant goes into insolvency on 31 December 2018 and vacates the UK Property.
- The value of the UK Property on 5 April 2019 is £15,000,000 (vacant possession).
- The UK Property is fully tenanted on 30 June 2019 (new 15 year FRI lease is entered into).
- The UK Property is sold on 30 January 2020 for £35,000,000.

Based on the above fact pattern, the seller should use the historic cost method to calculate the chargeable gain (£35,000,000 less £30,000,000, capital gain of £5,000,000) and not the current market method (£35,000,000 less £15,000,000, capital gain of £20,000,000).

Propco will be liable to pay corporation tax on the chargeable gain on a Direct Disposal and Holdco on an Indirect Disposal at the rate of 19%.

A final point to note is that an Investor who acquires shares in a UK property rich entity needs to consider any latent capital gain that it will inherit when it acquires such an entity. If the UK Property rich entity subsequently disposes of any UK Property held by it (i.e. by way of a Direct Sale), the value of the UK Property used to calculate the chargeable gain will not reflect the Investor's acquisition cost of the UK property rich entity. Instead, the UK property rich entity will be liable to UK corporation tax on the difference between the market value of the UK Property as at 5 April 2019 (if the UK Property was purchased prior to 5 April 2019, on the basis of the market value cost election mentioned above) and the disposal price.

If a latent capital gain is being inherited, the purchase price for the shares being acquired should be adjusted to take into account the latent tax charge (purchase price adjustment would be equal to 19% of the difference between the market value of the UK Property at the time the shares in the UK property rich entity are acquired and the market value of the UK Property as at 5 April 2019).