Taxation of non-resident investors in UK real estate

Key changes announced in the 2017 Autumn Budget

March 2018

Background

The UK government announced in the 2017 Autumn Budget that it is proposing to amend the rules governing the taxation of non-resident investors in UK property. From April 2019, the current exemption from capital gains tax for non-resident investors will be abolished. Draft legislation in relation to these changes will be published in the 2018 Autumn Budget. In addition, from April 2020, non-resident corporates holding UK property will be subject to UK corporation tax on their rental income profits, as opposed to UK income tax as at present.

These changes represent a fundamental departure from the existing regime and are likely to have an immediate valuations effect. Non-resident investors will need to consider the impact of these changes on their existing structures.

Capital gains tax

Current rules

Commercial property

- Currently, non-residents are not subject to UK tax on gains arising on the disposal of UK commercial property, provided it is held for investment purposes.
- Disposals of UK commercial property which is held on trading account are within the scope of UK tax.

Residential property

- Disposals of UK residential property by non-residents have been subject to tax in the UK since the introduction of non-resident capital gains tax ("NRCGT") from 6 April 2015.
- However, there are a number of exemptions to NRCGT, including disposals by diversely-held companies, qualifying unit schemes, qualifying open ended investment companies and life assurance companies holding property as part of their portfolio of investments.
- Certain types of residential property are also exempt from NRCGT, such as student accommodation and hotels.

Proposed changes from April 2019

What is the scope of the changes?

- All disposals by non-residents of UK property (commercial or residential) will come within the scope of UK taxation under one harmonised regime from April 2019.
- Indirect disposals of UK property will also be subject to the new rules. Broadly, a sale of shares will be within the scope of UK tax where 75% or more of the gross asset value of the company is derived from UK property and where the vendor has owned 25% or more of the share capital (or equivalent) in the previous five years.
- There will be a rebasing for tax purposes to April 2019 values for both property and shares in property rich companies. The rebasing will be optional for properties, but compulsory for property rich companies.
- Investors who are exempt from UK taxation by virtue of their status (such as sovereign immune bodies, UK and overseas pension schemes) will continue to be exempt on gains that arise to them directly. However, as currently drafted, exempt investors will suffer tax indirectly where disposals are made by entities in which they have invested that are not exempt in their own right (see next page).

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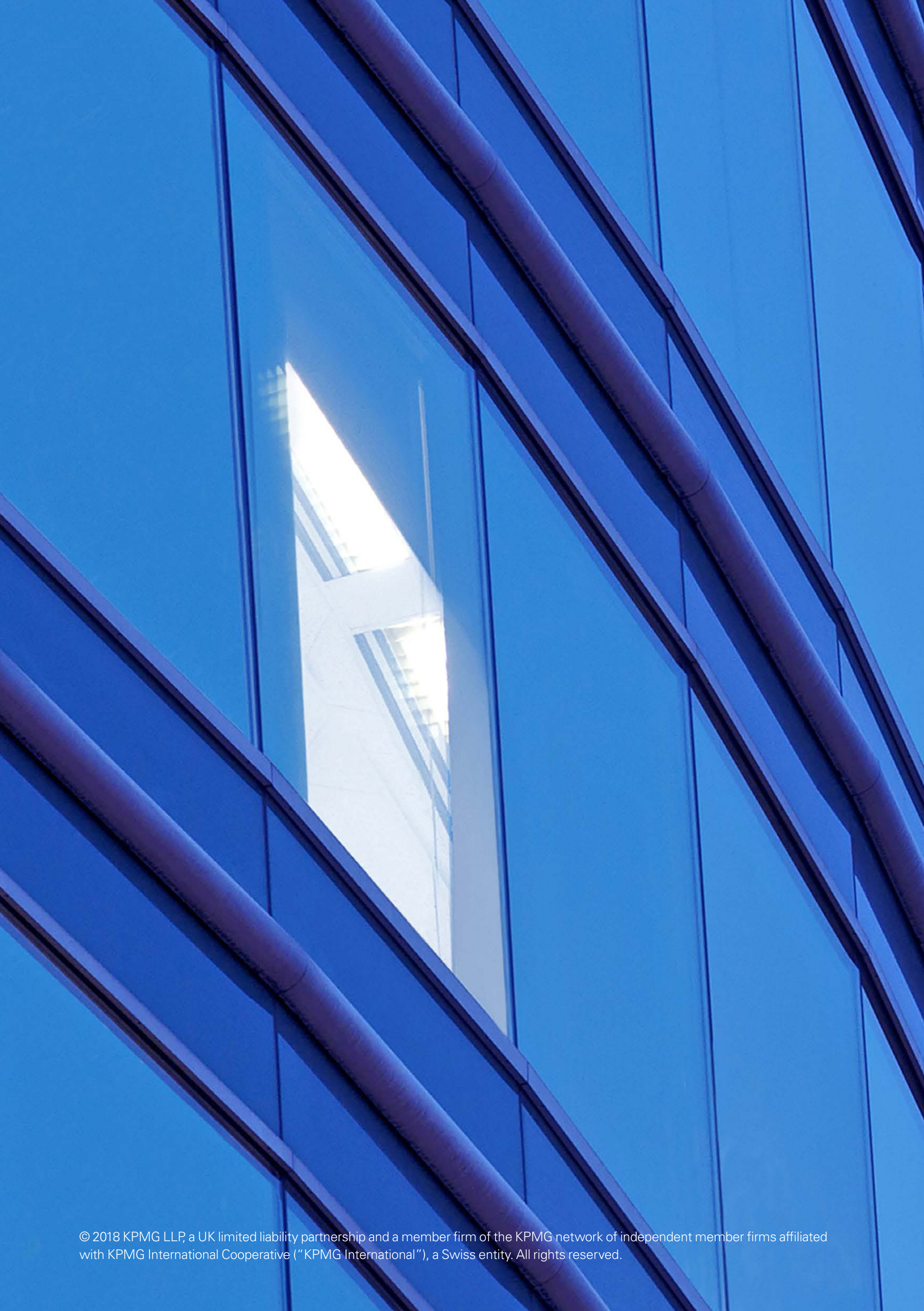

Who will be affected?

- Any non-resident who invests in UK property either directly or indirectly.

What are the main implications?

- The current value of investors' interests in UK commercial property may have been adversely impacted. Investors are likely to suffer price discounts for share sales where there is a latent capital gains tax liability in the property rich company. Exit routes and assumptions should be reassessed.
- Investors will need to carry out valuations of their properties and property-rich companies as of 1 April 2019. Whilst such valuations could potentially be deferred until the ultimate date of sale, this may not be feasible due to reporting requirements - for example where deferred taxes or fair values need to be reported to investors. Furthermore, our experience shows it may not be desirable to defer such work, as it could be more costly or burdensome to calculate after 2019.
- Investors based in Luxembourg may be able to obtain treaty relief to shelter tax on the sale of shares in property rich companies, although there are anti-avoidance rules that can deny treaty relief in some circumstances.
- Relief from tax on the sale of shares in property-rich companies may be obtained where the property-rich company is ultimately owned by qualifying institutional investors, such as registered pension schemes, overseas pension schemes, life assurance companies, sovereign immune investors, charities, investment trusts and authorised investment funds that are diversely held. Where the company is owned 80% or more by such institutional investors, there will be a full exemption from tax. Where the company is owned 25% - 80% by such institutional investors, there is a partial exemption from tax.
- Exempt investors will need to reconsider the structures through which they invest, particularly where they have invested into collective investment schemes. While they would be exempt on disposal of assets owned directly by them, under the proposed rules, this exemption may not be extended to gains on disposals made by tax-opaque entities at lower investment tiers.
- Cornerstone investors in funds will be likely to breach the 25% ownership test by virtue of being among the first investors in a fund. Representations have been made to HMRC that the 25% ownership test should be based on average ownership rather than an absolute threshold. Investors may wish to consider tax exempt vehicles such as a UK-REIT. For example, institutional investors may look to establish UK-REITs to hold UK property investments. UK-REITs are exempt from corporation tax on rental income profits and capital gains on the disposal of investment properties. In addition, where a UK-REIT is controlled by institutional investors, capital gains on the disposal of property rich companies within the UK-REIT are exempt from capital gains tax (under the UK Substantial shareholding regime). Furthermore, where a property investment company is sold out of a UK-REIT, there is a rebasing of the investment property to its market value at the date the company is sold. This means that there is no latent capital gains tax within the property investment company for a future purchaser. Although UK-REITs need to be listed, this can typically be done with minimum cost on exchanges such as TISE.
- The impact of these changes on proposed acquisitions should be assessed, particularly regarding exit assumptions and how this could impact current pricing.

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Rental income profits

Current rules

Currently, all rental income profits earned by non-resident companies are subject to UK income tax at 20%. The income tax rules are significantly less complex than the UK corporation tax rules that apply to the taxation of rental income profits earned by UK companies.

Proposed changes from April 2020

What is the scope of the changes?

From April 2020, non-resident companies holding UK property will become subject to UK corporation tax in respect of their rental income profits, as opposed to UK income tax as at present.

What are the main implications?

- Interest expense will in principle be tax deductible only up to 30% of the company's EBITDA. In some cases a higher amount may be deductible for a group company, depending on the overall type and level of financing within the group. A £2m de-minimis will also apply, although this is per group rather than per company.
- Tax relief for some expenses may be denied where the UK anti-hybrid rules apply. These rules can apply not only where hybrid financing instruments are used within the structure, but also where hybrid entities exist. In particular, this can apply to companies that are "checked open" for US tax purposes.
- Losses generated after April 2020 will be subject to restrictions on use. Broadly, where a company or group has taxable profits in excess of £5m in any year, losses can only be utilised against 50% of the profits in excess of £5m.
- Depending on their level of profits, companies may be brought within the corporation tax quarterly instalment payment regime, meaning that tax payments will be accelerated.
- Companies that are members of a group will be able to offset profits and losses by way of group relief if desired.
- Similar to the proposed CGT changes, the impact of the rental income profits changes on proposed acquisitions should be carefully considered. For example, the restrictions on tax relief on interest, other expenses and losses may impact IRRs and exit pricing adversely.

There will be a rebasing for tax purposes to April 2019 values for both property and shares in property-rich companies. The rebasing will be optional for properties but compulsory for property-rich companies.

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