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by Nicholas Aleksander

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by Nicholas Aleksander

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In this article, the author discusses the recent announcement by the U.K. government that tax will be charged on gains made by international investors on disposals of all types of U.K. land and buildings.

The U.K. has the largest commercial property market in Europe, attracting more than $31 billion of investment in the first half of 2017 (even after the Brexit vote). International investors dominate in London, lured by big buildings with long leases to established businesses and a stable legal environment; international investors account for about 75 percent of investment in property in central London.

The U.K. traditionally had not taxed international investors on capital gains derived from investing in U.K. land and buildings, and has thus long been a favored destination for international real estate investors who have consistently invested billions into both commercial and residential schemes. The U.K. has always been viewed as one of the most favorable real estate markets on the globe, but the landscape may be about to change.

The U.K. has always taxed rental income, although with a generous deduction for interest incurred on acquisition finance. It has also always taxed dealers in U.K. land and buildings. The antiavoidance provisions regarding property development activities were broadened in 2016. The country has taxed the gains international investors derive from some residential U.K. property since 2013 and extended those provisions in 2015.

The U.K. government announced in the autumn 2017 budget that it will tax gains made by international investors on disposals of all types of U.K. land and buildings: residential and commercial, and whether held directly or indirectly. The government has published a consultation document on the implementation of the new system, proposing a single regime for the disposal of interests in both residential and nonresidential property. The proposed changes, which are to take effect from April 2019, are intended to apply not only to direct disposals of U.K. immovable property, but also to indirect disposals — in other words, the sale of interests in entities whose value is derived from U.K. land and buildings.

In accordance with a technical note by HM Revenue & Customs, anti-forestalling measures will be introduced effective November 22, 2017 (the day the announcement was made), to prevent circumvention of the tax through treaty shopping.

The consultation document makes clear that the U.K. government's plan is to bring non-U.K. residents within the ambit of the U.K. tax on disposals of all kinds of U.K. immoveable property. That would more closely align the tax treatment of non-U.K. residents with that of residents and reduce the incentive for multinational groups to hold U.K. land and buildings through offshore structures.

The consultation relates to the implementation of that policy plan, not to its principle. Given the U.K. political climate, it is highly likely that the proposals will be implemented.

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Direct Disposals

The U.K. government intends that all gains accruing on disposals of interests in U.K. immovable property will be subject to U.K. tax with effect from April 2019. Nonresidents will be taxed on any gains made on the direct disposal of U.K. land and buildings, and disposals by nonresident widely held companies will be taxed. The tax rate on any direct disposals will be the U.K. capital gains tax (subject to the move to corporation tax for corporate owners, discussed below).

Nonresidential property owned as of April 2019 will be rebased to its value at that time with the intention that it will be taxed only on its subsequent appreciation in value. Gains arising on the disposal of residential property are already subject to the U.K. tax, and the rebasing point for residential property will remain April 2015. Gains arising from mixed-use property, or a change of use between April 2015 and April 2019, will need to be allocated between the elements using the different rebasing points.

The nonresident capital gains tax (NRCGT) regime excludes widely held companies, an exemption that will be removed beginning in April 2019. Gains will be computed in the same way as for U.K. resident investors, and any losses arising on the disposal of U.K. property will be available for offset against U.K. taxable gains. For companies subject to corporation tax, gains and losses will be treated like other capital gains and losses (with appropriate amendments to reflect the company's nonresident status). For other investors, capital losses will be available to offset capital gains arising on the disposal of other U.K. property.

Owners who are exempt from U.K. tax other than because of their nonresident status (such as some pension schemes or sovereign investors) will retain their exempt status under the new regime. If the property owner has made an overall loss on a direct disposal of the property but rebasing results in a taxable gain, the loss can be computed using the original acquisition cost.

Indirect Disposals

Disposals of significant interests in entities that directly or indirectly own interests in U.K. real estate will also be brought within the scope of U.K. tax. For tax to be imposed, the entity being disposed of must be "property rich," and the nonresident must hold at least a 25 percent interest in the entity or have held at least 25 percent at any time during the five previous years.

Gains will be calculated based on the interest being sold, using the normal rules that apply to the disposal of shares (or other investments). Antiavoidance provisions will apply the same way they would to resident taxpayers. Investors who are exempt from U.K. tax other than because of their nonresident status will retain their exempt status under the new regime.

Property Rich

An entity is property rich if at least 75 percent of its gross asset value at the time of disposal is derived from U.K. immovable property. That includes any shareholding in a company deriving its value directly or indirectly from U.K. property; any partnership interests; any interests in settled property; and any option, consent, or embargo affecting the disposition of the U.K. property. The test looks through layers of ownership to arrive at a just and reasonable attribution of value. The value of both residential and nonresidential U.K. properties will count toward the 75 percent; the value of non-U.K. property will not.

The property-richness test is applied to the gross value of the entity's assets, so liabilities such as acquisition finance are excluded. The test uses the market value of the entity's assets at the time of disposal.

If an entity is not property rich when the investor acquires his investment but later becomes property rich, the entire gain, not just the amount attributable to the period after the company becomes property rich (subject to April 2019 rebasing), is subject to U.K. tax. Rebasing to April 2019 is the only calculation permitted for investments held before that date (using the original acquisition cost is not permitted for indirect disposals).

The property-richness test will also be applied to the totality of entities being sold in a transaction. So, if an investor were to sell shares in a holding company that was not itself property rich but owned entities that were, the 75 percent

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test would be satisfied if, taken together, the entities being sold met the 75 percent test.

The Finance (No. 2) Act 2017 extended the substantial shareholder exemption (SSE) to qualifying institutional investors. Assuming the requirements of SSE are met, SSE will be available to exempt disposals of substantial interest in property-rich companies from U.K. tax.

25 Percent Ownership

The 25 percent ownership test is intended to exclude minority investors who may not necessarily be aware of the underlying asset mix of the entity and who are unlikely to have control or influence over the entity's activities.

In determining whether an owner has a 25 percent interest, the owner must look back over five years to see if the test was met at any time. Holdings of related parties will also be considered. Related parties will include persons who are connected (using the rules in the U.K. Corporation Tax Act) but also persons acting together, including when persons come together with a common object regarding an entity owning U.K. property. The acting together rules will be modeled on those in the U.K.'s corporate interest restriction provisions.

Rebasing to April 2019 will be applied to the interest held by the investor in the entity. Although the tax will be limited to gains accruing after April 2019, the lookback would take account of the owner's holdings before then (if within the five-year lookback period). So an investor who owns 50 percent of a U.K. property investment company but sells down to 24 percent before April 2019 would not avoid the new tax if she sold her remaining holdings before 2024, although the tax would be limited to the appreciation of the value of the 24 percent stake and would be rebased to April 2019.

Residential Property

The NRCGT rules will be extended to widely held companies and indirect disposals, and the exemption for life-assurance companies owning residential properties will be removed. Widely held companies will use April 2019 as the NRCGT rebasing point for all property disposals. Closely held companies will continue to use April 2015 as the rebasing point for direct disposals of residential property but will use April 2019 for disposals of nonresidential property. April 2019 will be the NRCGT rebasing point for all disposals of indirect interests, including interests in entities owning U.K. residential properties.

The U.K. government is considering harmonizing the regime for gains stemming from the Annual Tax on Enveloped Dwellings (ATED) provision with the wider proposals for taxing nonresident gains on U.K. immovable property. One section of the consultation document discusses the simplification and harmonization of the ATED rules.

Tax Treaties

It is a generally accepted principle of international law that the primary taxing rights over immoveable property belong to the state where that property is located. Because the U.K. has not historically exercised that right, it has not been concerned with ensuring that the right is fully reflected in its tax treaties, so some treaties will require amendment to give the U.K. full taxing rights over indirect disposals. Unlike in the United States, amendments to U.K. domestic tax law do not override existing tax treaties.

All U.K. tax treaties include a provision allowing the U.K. to impose tax on a direct disposal of U.K. immoveable property. Some more recent tax treaties include a securitized land provision that allows the U.K. to tax gains on the disposal of interests in entities that are U.K.-property rich. But many older treaties do not include that provision and allocate taxing rights on the disposal of interests in an entity that is U.K.-property-rich to the investor's country of residence. Even if a treaty includes a securitized land provision, it might apply only to shares in companies, not to interests in other entities (such as partnerships or unit trusts). In some treaties, the securitized land provisions apply only to the investor's disposal of its interest in the entity, not to disposals by underlying entities.

When there is no tax treaty, the U.K. will be able to apply the indirect disposal charge without constraint. For treaties that do not allow that, the U.K. government has said it plans to negotiate with the other state to amend the treaty. Subject to anti-forestalling provisions, if a nonresident investor disposes of his interest in a U.K.-

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property-rich entity before the amendment takes effect, he may be able to benefit from any exemption from U.K. tax in the treaty.

However, an anti-forestalling rule will apply to prevent investors from being able to reorganize their affairs to take advantage of a treaty exemption to which they are not already entitled. The technical note on the anti-forestalling rule states that the rule will apply to any arrangements entered into on or after November 22, 2017, with intent to obtain a tax advantage stemming from those new tax provisions through the operation of a treaty exemption. In those circumstances, HMRC will be able to counteract the tax advantage by means of a tax assessment or disallowing a claim. Precisely how it will exercise that power is not stated, and implementation and enforcement of the anti-forestalling rule might not be straightforward.

Collective Investment Vehicles

U.K. REITs

The profits and gains of the property rental business of a U.K. real estate investment trust are exempt from tax, and there is no intention to change that. A U.K. REIT is required to distribute at least 90 percent of its rental income by way of dividend, which is then taxed in the hands of its shareholders. There is no requirement for a U.K. REIT to distribute capital gains, but if those gains are distributed by way of dividend, those dividends will also be taxable in the hands of the shareholders.

U.K. resident shareholders are taxed on gains realized on the disposal of shares in a U.K. REIT, whereas nonresident shareholders are not. Under the new rules, if a U.K. REIT satisfies the property-richness test, a nonresident disposing of shares in the U.K. REIT will be within the scope of U.K. tax (if the nonresident has at least a 25 percent interest in the REIT at the time of disposal or in the prior five years).

The intention is that a similar analysis would apply to other tax-exempt U.K. collective investment vehicles (such as property authorized investment funds and exempt unauthorized unit trusts), and the vehicle itself would not be subject to tax on the direct disposal of U.K. property. However, a nonresident investor would be subject to U.K. tax on a disposal of its investment in the vehicle if the vehicle was property rich and the investor's interest exceeded 25 percent (at the time of disposal or in the prior five years).

Overseas Collective Investment Vehicles

Some funds are outside the scope of U.K. tax on capital gains only because of their nonresident status — which will change with the new rules. Direct disposals by those kinds of collective vehicles will come within the scope of U.K. tax effective April 2019. Also on that date, disposals by investors of their interests in those vehicles will become taxable if the vehicle was property rich and the investor's interest exceeded 25 percent (at the time of disposal or in the prior five years).

Corporation Tax

In March the U.K. government published its consultation on nonresident companies subject to income tax and NRCGT, which sought views on bringing closely held companies that own U.K. property within the scope of U.K. corporation tax. The U.K. government has announced its intention that nonresident companies that own U.K. property will be brought within the scope of U.K. corporation tax for their U.K. property business.

The move to the corporation tax regime will have effect from April 2020. The government has announced that the main corporation tax rate will be 17 percent for the fiscal year 2020, so there will be a reduction in the headline rate of tax as a result of the change.

The regime for tax relief for financing costs is somewhat more flexible under corporation tax rules than under income tax rules, and technical problems that can arise when a property is refinanced should no longer apply. However, companies subject to corporation tax are also subject to interest restrictions (broadly, 30 percent of consolidated earnings before interest, taxes, depreciation, and amortization with a de minimis of £2 million). There are limited exceptions for public infrastructure projects. Those complicated rules are outside the scope of this article, as are the application of the hybrid entity rules and the carryforward loss limitations, which will also become applicable.

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Administration and Compliance

Nonresident direct owners of U.K. property are already within the scope of U.K. tax (at least for rental income) and will be filing U.K. tax returns for rental income under the nonresident landlord scheme. However, investors in property-rich entities will not be used to filing U.K. tax returns.

HMRC anticipates that most persons within the scope of the new charge will be aware of their obligations to file U.K. tax returns and pay U.K. tax. HMRC expects most taxpayers to comply; however, to ensure it knows about transactions, reporting obligations will be imposed on U.K. professional advisers. Under the current NRCGT regime, a seller must electronically report a transaction to HMRC within 30 days of completion. If the seller is already within the self-assessment regime, it may defer payment of the tax until due under the normal reporting process. Otherwise, it must pay within 30 days.

The same process will apply to the new tax for investors who are not within the scope of corporation tax. It will apply to direct and indirect disposals or residential and nonresidential properties. Companies subject to corporation tax will be required to register for self-assessment with HMRC, file returns, and pay any tax within the normal corporation tax self-assessment process.

To ensure HMRC is aware of indirect disposals, reporting obligations will be imposed on advisers who:

- are based in the U.K.;
- are paid a fee for advice or services relating to a transaction falling under the new rules;
- have reason to believe that a contract has been concluded for a disposal falling within the new regime; and
- cannot reasonably satisfy themselves that the transaction has been reported to HMRC.

The time limit for the adviser is 60 days, which should allow time for the nonresident to report the transaction himself and show an official receipt for the report to his adviser, so that the adviser knows whether the transaction has been duly reported.

HMRC will be able to recover unpaid tax from a U.K. representative of a nonresident investor and from related companies. Penalties and interest will be imposed for failure to comply.

Conclusion

In some respects, the move to impose tax on foreign investors in U.K. real estate should come as no surprise. In a time of austerity, raising tax receipts is an important part of public finances, and taxing overseas investors (who have no vote) is an obvious target. Imposing capital gains tax on international investors in real estate brings the U.K. in line with most other jurisdictions.

So far, there is only a consultation document. The government has said it will publish its response to the consultation in summer 2018, together with draft legislation. The actual legislation will be introduced with the Finance Bill in April 2019, to take effect from that month. Until the draft legislation is released, it is difficult to provide anything other than a high-level overview of the proposals. However, some immediate thoughts come to mind.

First, consideration should be given to the timing of capital expenditure. If an amount to be spent on capex will not be immediately reflected in the value of the building, consideration should be given to deferring the expenditure until after April 2019. That is so the full amount of the expenditure is treated as an enhancement expenditure for base cost purposes, rather than getting lost in the rebasing valuation in April 2019.

Second, if property is owned through a company incorporated and resident in a country with a favorable tax treaty with the U.K., disposals of interests in that company may be exempted from the new indirect disposal charge under the treaty (which under U.K. general tax rules will trump domestic law) at least until treaty is amended. If those structures can be kept in place without changes, they should.

However, the anti-forestalling provisions will counteract any attempt to redomicile a structure that does not already benefit from treaty reliefs into a favorable treaty jurisdiction. The technical note does not say how the anti-forestalling provisions will apply, and the rules may be difficult to implement without the consent of the other jurisdiction.

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Third, international investors who benefit from U.K. tax exemptions (other than because of their nonresident status) might want to restructure their ownership arrangements to benefit from their tax-exempt status, particularly if they own U.K. property through special purpose vehicles resident outside the U.K. That could be of particular relevance to some overseas pension funds and sovereign investors that would not be liable for U.K. tax if they held property directly (or through fiscally transparent entities). Any restructuring might need to be put into place before April 2019 to ensure it does not trigger a tax charge under the new regime.

Fourth, the structure of the proposed arrangements could give rise to tax being charged at multiple levels if property is held by an international property investment fund through special purpose vehicles. Depending on the proportion of U.K. and non-U.K. properties held by the fund, charges could arise on the disposal of individual special purpose vehicles (owning U.K. properties) and on the disposal by investors in their holdings in the fund. Staging and timing of disposals might mitigate the effect of potential double tax, so that when investors realize their holdings in the fund, it is no longer property rich.

Fifth, the use of tax-efficient onshore U.K. structures (such as REITs or property authorized investment funds) is likely to become more prevalent, if only to restrict any tax charge to just one level, rather than several. However, the consultation document states that the government will consider whether changes to those regimes will be required to prevent tax avoidance.

Sixth, the consultation document does not clarify the interaction between the new provisions and the substantial shareholder exemption. While the application of that exemption to qualifying institutional investors is preserved, it is unclear whether it would apply to disposals that would otherwise qualify for the exemption. That is important to active trading businesses that have a significant property component to their overall valuation (such as hotels). Depending how the provisions are written, in OpCo-PropCo structures there might be benefits in migrating PropCos into the U.K. so that the substantial shareholder exemption can apply to disposal of the entire business.

Finally, challenges will also bring opportunities. Although some investors may find that their after-tax returns from U.K. property investment will be diminished as a result of the changes, investors who are already within the scope of, or exempt from, U.K. tax will be no worse off, and might find opportunities for investment. It would be no surprise if the specter of this legislation brings into play "price chip" discussions as cash-rich investors seek to capitalize on uncertainties that inevitably will feature in the minds of sellers. ■

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