STEPHENSON HARWOOD

9 JULY 2020

Update on using structures to hold UK real estate

UK taxation of real estate

Tax	Payer	Comment	Rate 2020/21
Income Tax (residents) **Withholding Tax (non-residents)**	Individuals, Trusts Person paying rent to non-resident	Applies to rental income, trading profits and to profits from overage and other arrangements that are equated to trading profits. Income tax must be deducted from payments	Highest rate is 45% 20%
Capital Gains Tax	Individuals, Trusts	Applies to gains from disposals of property and shares in property rich companies. Normally measured by reference to actual price but market value may be required. Exemption may be available for property used as principal private residence.	20% 28%
Corporation Tax	UK corporates UK branches Non-resident corporates	Applies where an individual would pay income tax or capital gains tax and calculated on a similar basis. Non-resident corporates in charge on capital gains from 1 April 2019 and for income from 1 April 2020.	19%
Annual Tax on Enveloped Dwellings (ATED)	Company owning residential real estate	Applies to properties used by connected persons, even if market rent paid. Exemptions available for property rental and development but must be claimed.	20%
Stamp Duty Land Tax (SDLT)	All – normally paid by buyer/lessee	Transaction tax on land transactions paid on sales, assignments, grants of leases etc. May also be paid on agreements for lease and other contracts if there is "substantial performance" by payment or taking possession. A range of exemptions and reliefs apply to specific situations.	Depends on type of property, transaction and value Max 5% Commercial Property Max 15% Residential Property
Stamp Duty	All – normally paid by buyer	Transaction tax on share transfers – not normally paid if the shares are issued by a non-UK company.	0.5%
Value Added Tax	Supplier of goods or services	Land supplies are *prima facie* exempt but supplies of non-residential land can be elected into VAT. This is normal and allows recovery of VAT on costs incurred. New reverse charge applies to some supplies of construction services to prevent tax evasion.	20% standard rate 0% first grants of residential property
Inheritance Tax	Individuals, Trusts	Applies to residential property, shares in company deriving value from residential property or loans made to acquire residential property	40% on death. 20% on transfer to trust. Maximum 6% for anniversaries and exits from trusts

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Please note: the tax rates given are as at 9 July 2020

Never-ending changes

Where are we now?

Taxation of UK property – wholesale change

Summary

The changes in taxation of UK property amount to a revolution.

- 2012 15% SDLT rate for most acquisitions of UK residential property by a corporate
- 2013 ATED and ATED CGT applied CGT for the first time to non-resident corporate owners of unlet residential property
- 2015 NRCGT extended CGT to non-resident owners of let residential property
- 2016 Additional 3% charge on purchases of second homes
- 2016 new regime for taxing profits from dealing in or developing UK land: structures used by non-residents, eg using tax treaties, rendered ineffective, no rebasing
- 2017 IHT amended to apply to equity and debt interests in residential property held through offshore structures
- 2019 gains taxation applied to non-resident owners of commercial property and indirect sales of “property-rich” companies/unit trusts and ATED-related CGT repealed
- 2020 corporation tax regime applies to rental income of non-residents

Is it still worth using offshore structures?

2019 changes – extension of CGT

- **If it looks like UK land...**
- **Or something that holds UK land...**

STOP AND THINK

- **CGT regime extended from 6 April 2019 to disposals of all UK land AND shares in "property rich" companies**
- **Applies to disposals of UK land (residential and commercial) by all persons, including companies, trusts, foundations etc**
- **Individuals and trusts pay CGT; companies pay corporation tax on the gain**
- **CGT rates:**
  - 18/28% for residential
  - 10/20% for commercial
- **Corporation tax rate currently 19%**
- **Watch out for mixed-use!**
- **And interaction with s.3 (previously s.13) TCGA 1992...**

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2019 changes - continued

Watch out for indirect disposals

- Disposal of an asset deriving at least 75% of its value from UK land; and
- The person disposing has a "substantial indirect interest" in the UK land

"assets deriving at least 75% of their value from UK land" **property rich**

- right or an interest in a company (but not a partnership); and
- At disposal, at least 75% of the total market value of the company's qualifying assets derives (directly or indirectly) from interests in UK land.
- Trace through structures but not normal commercial loans.

"substantial indirect interest"

- broadly, a 25% interest in the entity held at any time in the two years before disposal unless time held is "insignificant"
- Aggregate interests held by connected persons

And linked disposals

Where dispose of a number of entities in the same arrangement, their assets are aggregated to determine whether the 75% test is met

Losses are ring-fenced

2019 changes - continued

Some good news!

- **ATED-related CGT has gone**
- **Automatic rebasing to April 2019 value for land brought within the scope for the first time (for residential property already within the scope of NRCGT the rebasing date remains 6 April 2015) – can elect out.**
- **Trading exemption**
    - For indirect disposals where reasonable to conclude that the UK land from which the asset derives its value (directly or indirectly) is used for trading purposes

Compliance

- **Get your return done quickly – 30 day reporting for CGT from date of disposal plus payment on account at the same time of the tax notionally due if the tax year had ended at the date of the disposal**
- **Corporation Tax returns fall within the usual CT regime but disposal may mean a non-UK company comes within the scope of CT for the first time and has to register with HRMC. No need to file return if no gain or allowable loss to report but note that election can only be made on a return.**

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SDLT Shock! – the First Tier Tax Tribunal decision in *Hannover*

***Hannover Leasing Wachstumswerte Europa Beteiligingsgesellschaft MBG and another v HMRC** (*released April 2019) confirms advisors' fears for SDLT planning.

The case involved the sale of a property which, pre-sale, was held by a limited partnership underneath a Guernsey property unit trust ("GPUT").

Hannover, the buyer, wanted to acquire the land directly but also to benefit from transfers of the GPUT units not being subject to SDLT. It was therefore agreed that, as a first step, the property would be transferred from the partnership to the GPUT trustee so that the partnership could be eliminated from the GPUT.

Hannover would then buy the units in the GPUT and, immediately after it had done so, would take the property out of the GPUT.

Technically, each step in the transaction appeared to attract no, or minimal, SDLT. However, HMRC argued that section 75A Finance Act 2003 (entitled "*Anti-Avoidance*") applied and that SDLT was therefore payable as if the partnership had sold the land directly to Hannover.

The taxpayer argued that the Tribunal needed to look at the purpose of section 75A:- prevention of tax avoidance and that this meant that section 75A was limited to tax avoidance schemes or structured transactions where the tax saving was contrary to the scheme of the tax legislation. It should not apply to a series of transfers which merely happened to be part of the same commercial deal.

The taxpayer pointed out that HMRC's own guidance manual said that section 75A applied only where tax avoidance was present and that HMRC had also publicly accepted that selling shares in a company, instead of selling land and incurring SDLT, was not abusive tax avoidance.

The Tribunal disagreed. Section 75A contains a number of conditions and, since they were satisfied, HMRC had no discretion whether to charge SDLT. It made no difference whether the taxpayer had a tax avoidance motive or whether the transactions could objectively be described as tax avoidance. The guidance in HMRC's manual was "*either irrelevant or wrong*".

Comment:

This decision is important on many levels and is not intended to be appealed.

It will make it harder to unwind historic structures where an arm's length buyer prefers a "clean" structure.

More generally, it raises the question whether HMRC can (or must) look at any set of commercially interdependent transactions to see if there is an alternative, one step, transaction which would produce a higher amount of SDLT.

This creates significant uncertainty for buyers and sellers in all but the most straight forward transactions and we are likely to see more parties choosing to include terms in their arrangements to cover possible challenges by HMRC.

HMRC have also been told that their published guidance is incorrect. Taxpayers and HMRC staff are likely to have relied on that guidance. Will we see HMRC bringing discovery assessments to secure taxes on closed transactions? If so, will Taxpayers be able to protect themselves by showing that they relied on HMRC's guidance?

The Tribunal also observed that HMRC had been seeking to narrow by guidance legislation which HMRC itself considered to have been too broadly drafted.

Being "taxed by law and untaxed by guidance" is an increasingly common feature of the tax code – the anti-avoidance rules on Transactions in Land are another example - where HMRC claims discretionary powers which aren't actually in the legislation.

It is unlikely that the comments of one Tribunal judge will change HMRC's approach here, but taxpayers need to look closely at the law and be cautious about relying on HMRC guidance.

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2020 changes – corporation tax on rental income

Rental income for companies now within the corporation tax regime rather than the income tax regime from 6 April 2020

Which means…

- **19% rate of CT rather than 20% rate of IT**
- **Calculated under normal CT principles**
- **Deductions for expenses incurred "wholly and exclusively" for purposes of the business**

BUT Corporate interest deductibility restriction (CIR) applies

- Net expenses deductible restricted to an amount commensurate with activities taxed in the UK, taking account of borrowing from third parties.
- If net interest expense of group is less that £2m then no restriction; if over £2m, rules impose a cap on interest expense deductible

AND Restrictions on loss relief

- Relief for losses of a UK property business are first given by deducting the loss against total profits of the company.
- Any loss not relieved by this deduction can carry forward to next accounting period or be surrendered to another group company
- Carry forward rules are tight – need to carry on UK property business for next accounting period and claim within two years.

2020 changes - continued

Or no change!

Non-resident Landlords scheme still applies

No need to register for CT and file a CT return if the CT liability is fully offset by tax deducted under the NRLS (HMRC guidance from Jan 2020)

How much to hand over?

Tenants/agents are allowed to deduct expenses from the sum to be paid to HMRC provided the tenant/agent is reasonably satisfied those expenses are deductible from the profits of a property rental business and the tenant/agent has paid those expenses.

But how much can be deducted for financing costs? How many tenants/agents know the non-resident's position under the CIR scheme?

Taxation of Income from Land (Non-Residents) Amendment Regulations 2020

- Agent election to HMRC to agree the finance costs to be deducted – painful and convoluted but allows agent to deduct finance costs without knowing CIR position of the group

- **Compliance**
- Hello CT returns; goodbye SA700. Complexity and added paperwork…
- Requirement to notify HMRC of chargeability except companies already within NRLS who will be transitioned automatically (should have received UTRN by 30 June 2020)
- Agent authorisation not transitioning automatically – resubmit.

5AMLD – changes to the Trust Register

- Expanded scope of TRS now includes any non-EU resident trust which acquires UK land or property on or after [10 March 2020]

- Only applies if land acquired post [10 March 2020], not pre-existing holdings

- More limited amount of information to be provided than where there is a UK tax liability

What does the future hold?

More changes?

SDLT surcharge

- Announced at Budget 2018 & confirmed at Budget 2020
- Applies from 1 April 2021
- Proposal to impose 2% surcharge on non-residents acquiring residential property
- Technical details of charge promised but not yet forthcoming

Who is affected?
Determining non-UK residence

- Individuals: if have spent <183 days in the UK in the 12 months preceding the transaction
- Companies: incorporated or central management & control outside the UK*
- Partnerships: if one or more partners is non-UK resident
- Trusts: residence of the trustees, beneficiary or settlor can be relevant

Who is affected?

Certain UK companies

- UK resident close companies under direct or indirect control of one or more non-residents
- Does not apply to entities treated as companies
- Close company – s 439 CTA 2010 test
- Control – s450 CTA 2010 test
- Use direct acquisition residence test to determine if participators are non-resident

Who is affected?
Determining trust residence

- Bare trust – beneficial owner's residence status
- IIP – residence of beneficiary with right to occupy/income relevant
- Discretionary trust – residence of trustees used, applying usual IT/CGT test
- Watch out if only partial IIP & acquisition of multiple properties as this means trust treated as purchaser (& beneficiary's residence ignored)

Refunds, reliefs & exemptions

- Refund for individuals who then spend >183 days in the UK in the 12 months following the transaction
- Possible relief for Crown employees who are subject to IT although non-resident
- Surcharge applies to SDLT rate after operation of other reliefs (eg first time buyers' relief or multiple dwellings relief)
- Does not apply to mixed use or acquisition of >6 dwellings

Registration of Beneficial Ownership of Overseas Companies

What is it?

- Public register of beneficial owners of overseas companies owning UK property
- Due to apply from 2021
- Exception for companies registered on an "equivalent register"
- Land Registry will not register any dealing of the property unless the overseas entity can provide evidence of compliance

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Registration of Beneficial Ownership of Overseas Companies

What has to be disclosed?

- Disclosable information on individuals includes: name; nationality; country of residence; address for service and nature of control over the company

- Beneficial owners will also need to provide their date of birth and usual residential address but this information will not be made public under the current proposals

- The draft bill requires overseas entities to update (or confirm) their registered information annually

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Registration of Beneficial Ownership of Overseas Companies

Failure to comply

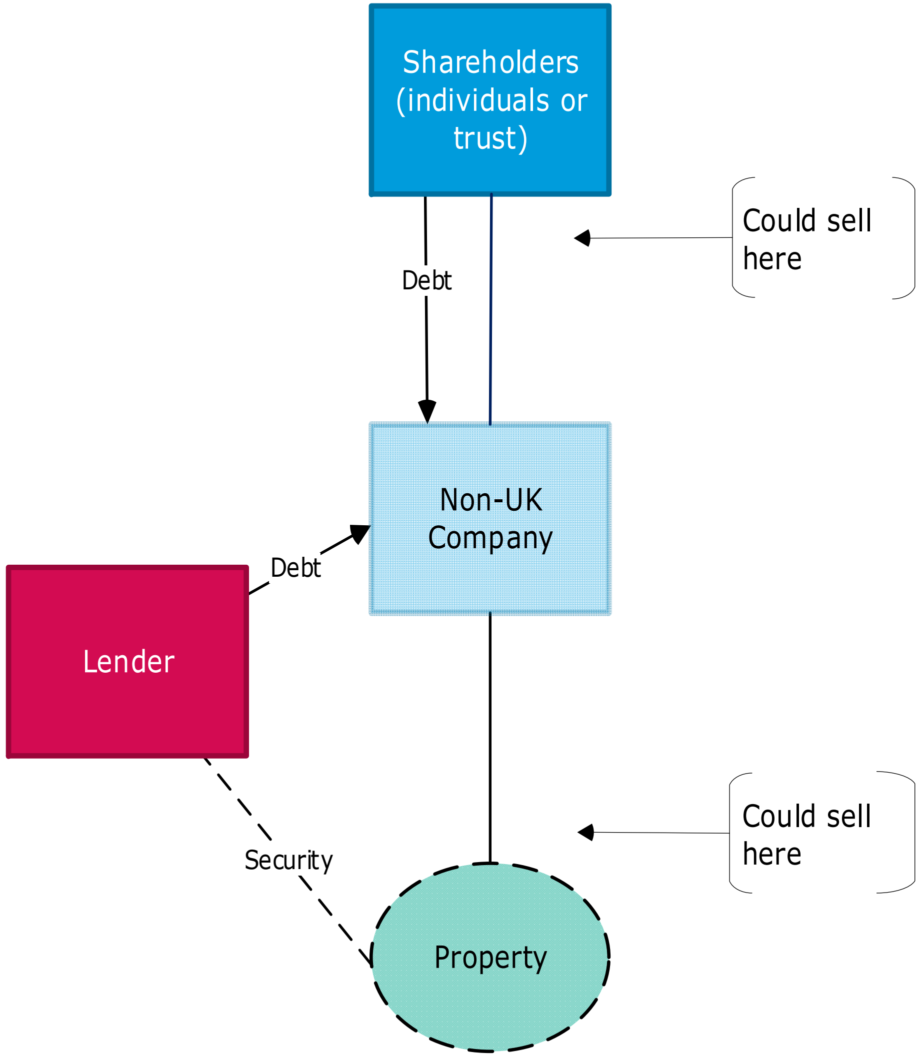
- Failure to register and disclose will be a criminal offence committed by the overseas entity and each of its officers, punishable by fines

- In addition, will prevent an overseas entity from dealing with UK property:
  - buying or selling,
  - taking or granting a lease of 7 years or more, or
  - granting a charge over property

- A restriction will be placed on the title to the relevant property

Does it still make sense to use a structure?

Residential property - occupied or available to family
Using a company



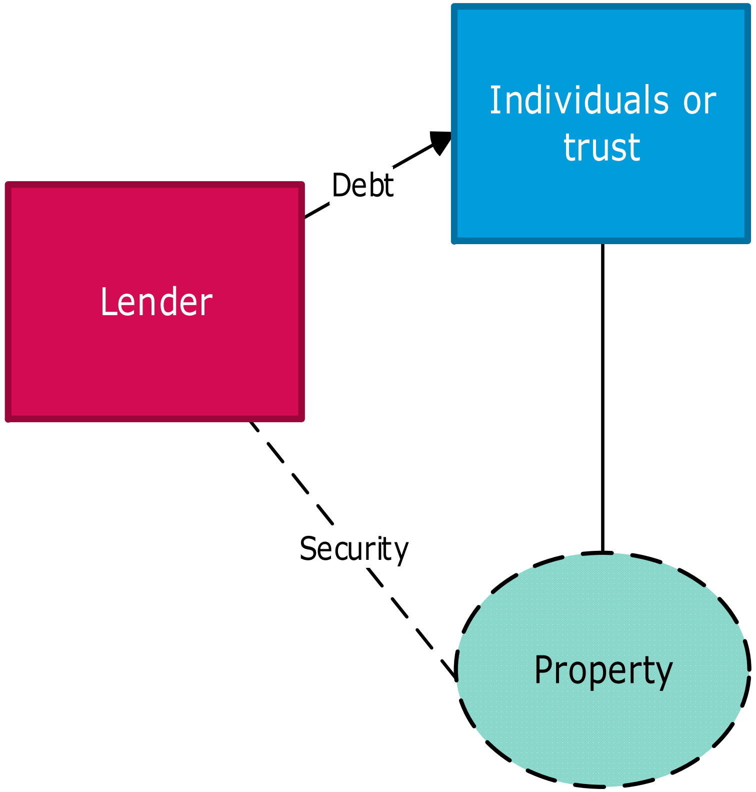
Significant features

- Historically frequently used – one of the most common ways to hold property (with or without a trust)
- Provides privacy
- Tax advantages have been eroded since 2013
- Annual Tax on Enveloped Dwellings payable by the company (between £3,650 to £232,350)
- SDLT at 15% on acquisition
- Company pays tax on gains at corporation tax rate
- Shareholders pay tax on gains on disposal of shares
- Possible SDLT charge on sale of shares in company following *Hannover* decision?
- Subject to IHT on value of property; deduction should be given for debt
- Possible double IHT charge if trust owns company and settlor is not excluded
- Anti-avoidance rules can apply if any UK resident individual shareholder or beneficiary of trust

Better now to own directly but de-enveloping can be costly

- SDLT if external borrowing and risk of SDLT if the anti-avoidance provision applies
- IHT exit charge if held in trust
- Capital gains tax on gain in shares, and if liquidate company, also on gain in property value
- Anti-avoidance rules could apply if UK resident individual shareholder or beneficiary of trust (either in occupation or if receives shares)

Residential property - occupied or available to family
New acquisitions



Direct ownership

- Can split between family members to reduce IHT exposure
- Watch gift with reservation rules for IHT
- May avoid CGT on disposal if used as residence & conditions met
- Nominee company could hold legal title to protect privacy (but see proposed beneficial ownership register)
- SDLT additional rate applies if own property anywhere else in the world
- SDLT mixed use? Following *Hyman v Revenue & Customs [2019] UKFTT 469* likely to need to use any land for a separate, i.e. commercial, use to avoid it being treated as grounds
- Loan from trust/company/individual to acquire, maintain or enhance the value of UK residential property is relevant property for IHT. In addition any money or assets made available as security or collateral for such a loan are also subject to IHT

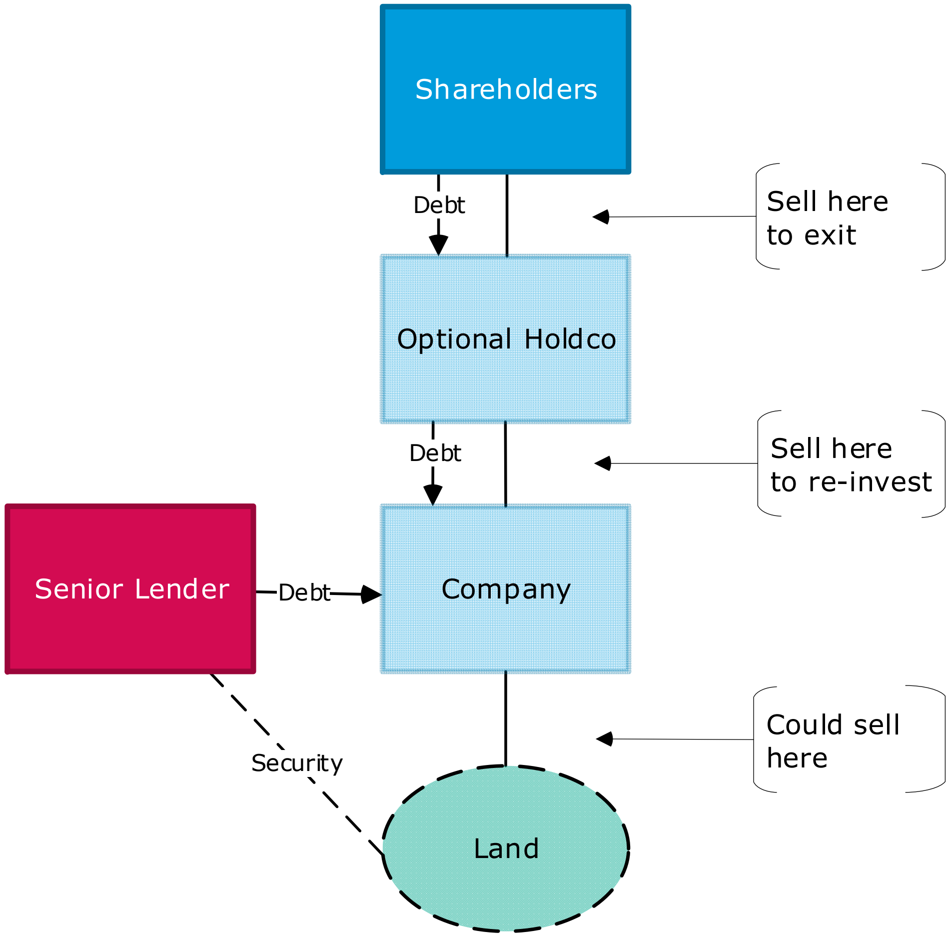
LLP ownership

- Can use an LLP as alternative to achieve results above with individuals as partners
- Can provide privacy protection (but see proposed b. ownership register)
- Transfer LLP interests to adjust split between family members but watch SDLT position and CGT if between connected persons and has increased in value. Adjustment would be a gift and a PET for IHT.

Trust ownership

- Can be efficient if settlor excluded from benefit and family intends to hold property long-term
- SDLT additional rates apply to acquisition by a discretionary trust. If beneficiary has right to occupy, consider their position to see if additional rate applies
- Relief from CGT may be available if property is occupied by a beneficiary

Keeping it simple – Company for let residential and commercial property



Significant features

- Simple, quick and cost-effective to set up; limited liability; shareholder agreement between investors; unlikely to be regulated
- Can exit the investment either by a share sale or sale of the property itself
- No special tax exemptions
- No ATED

Existing structures need to be reviewed

- Offshore company gains subject to tax (from April 2015 for residential and 2019 commercial)
- Offshore company property income profit subject to corporation tax rather than income tax from April 2020: different rates and interest deduction rules
- Gains on indirect disposals of UK property by disposals of shares in "property-rich" companies by 25% shareholder caught from April 2019
- Non-exempt resident and non-resident shareholders may be taxable on profit extraction
- Residential property subject to IHT even if held through offshore structure
- Pay SDLT on property acquisitions, no seeding relief; SD potentially not applicable to offshore company share sales

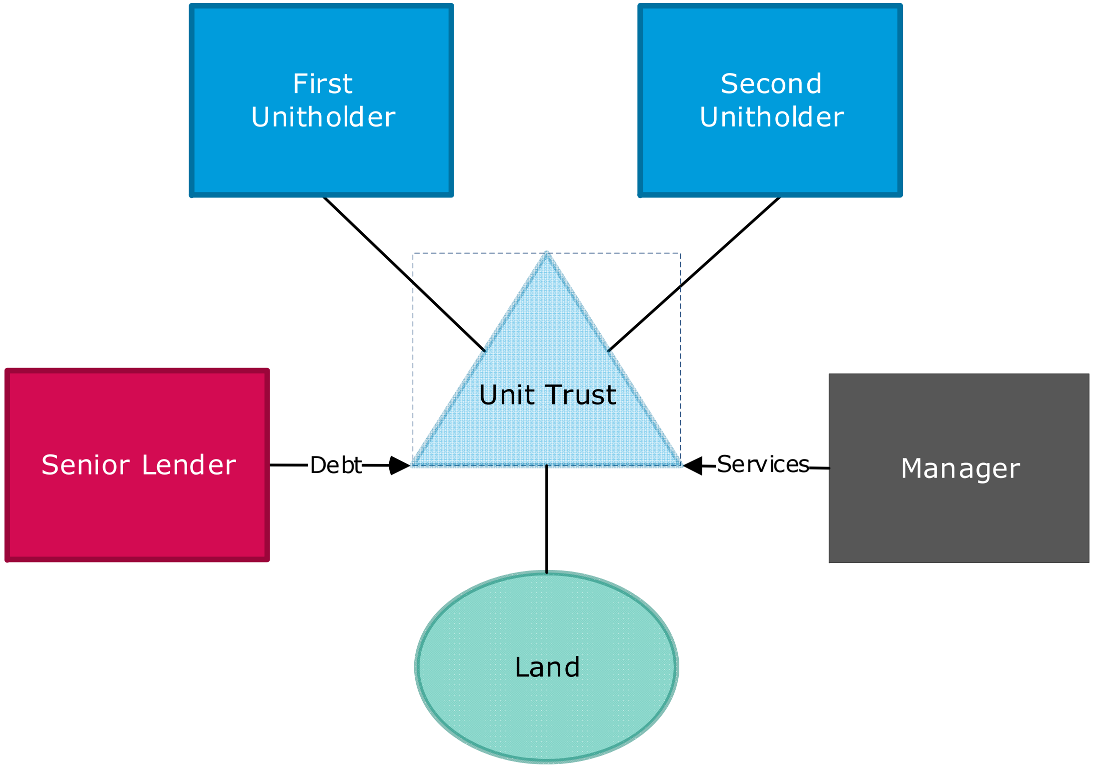
Planning

Is offshore worth it: SD, flexibility on distributions, VAT, board meetings

Not suitable for tax exempt investors: tax leakage at company level

Anti-avoidance rules may apply gains tax to pre-2015/19 gains of UK residents

Jersey Property Unit Trusts (JPUTs)



Comment

Exempt unauthorised units trusts (EUUTs) are a potential alternative to JPUTs but have not been particularly common historically as JPUTs are well known and offer equivalent tax benefits. There may also be a perception that EUUTs were associated with tax avoidance. However, they effectively convert trading profits to non-trading profits so may be useful in specific circumstances for exempt investors where there is a trade (or risk of trading) and such a trade would be taxable for the exempt investors (e.g. a pension fund).

Significant features

- Not as simple as company; likely to be regulated in Jersey
- Can exit the investment either by a sale of units or sale of the property itself
- Does not have separate legal status and acts by its trustee(s).
- Additional cost of Jersey legal advisers and company service providers to be factored in.
- JPUT is tax transparent for income and can move gains tax level to investors by electing to be transparent or (if widely held) exempt for gains

Existing structures need to be reviewed

- Absent an election the JPUT will be subject to corporation tax on gains
- Corporate unitholders will be subject to the corporation tax regime from April 2020 and gains tax on indirect disposals of UK property by way of disposal of units
- SDLT/SD treatment as for offshore companies

Planning

- Suitable as closed-ended type vehicle for exempt or mixed investors
- Non-tax exempt investors may prefer a simple company structure but could invest through a corporate blocker.
- Elected JPUT will be attractive for exempt investors to avoid tax leakage at company level

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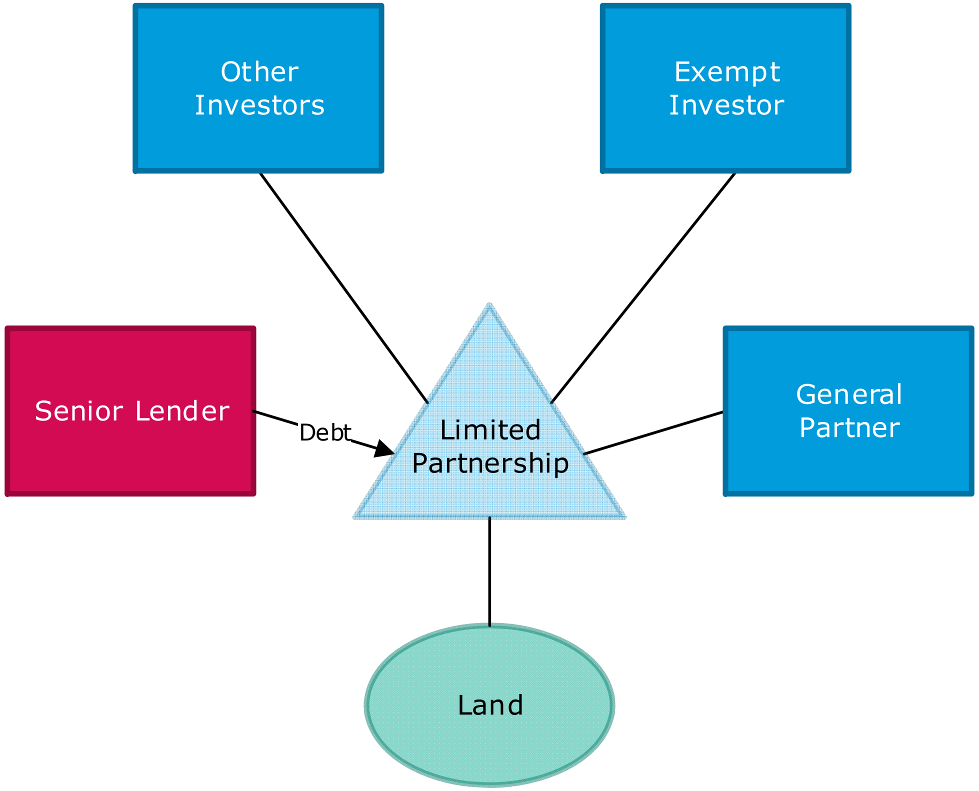
Limited Partnerships



Significant features

- Limited liability for Limited Partners provided they do not take part in management
- If partners wish to manage, an LLP could be used
- Privacy benefits – LP agreement is not made public and LP's accounts are not generally disclosed
- An English LP will normally require an FCA authorised operator so a Guernsey Partnership may be preferred
- More cumbersome to transfer interests in an LP
- Fully tax transparent for income and gains on arising basis
- Non-tax exempt investors may choose to invest through a corporate entity to reduce tax rate on income and gains
- Pays SDLT on land acquisitions from and sales to third parties; SDLT also normally chargeable on changes in partners; benefits on seeding and change of LP interests within a family or group

Planning

- Suitable for non-exempt investors (who may prefer to invest through a corporate "blocker") and exempt investors (for whom no tax leakage)
- Changes of offshore LP interests between family or connected parties may be achievable without gains tax or SDLT, so potentially useful IHT planning vehicle
- Consider transparency elected JPUT: transparency, SD free transfer of units, but more regulation

Comment

Partnerships do not have any particular benefits over JPUTs for investors requiring tax transparent structures (i.e. in order to benefit from their exempt status) and are not wrappers for SDLT purposes (meaning, unlike JPUT unit transfers, transfers of partnership interests will potentially be subject to SDLT).

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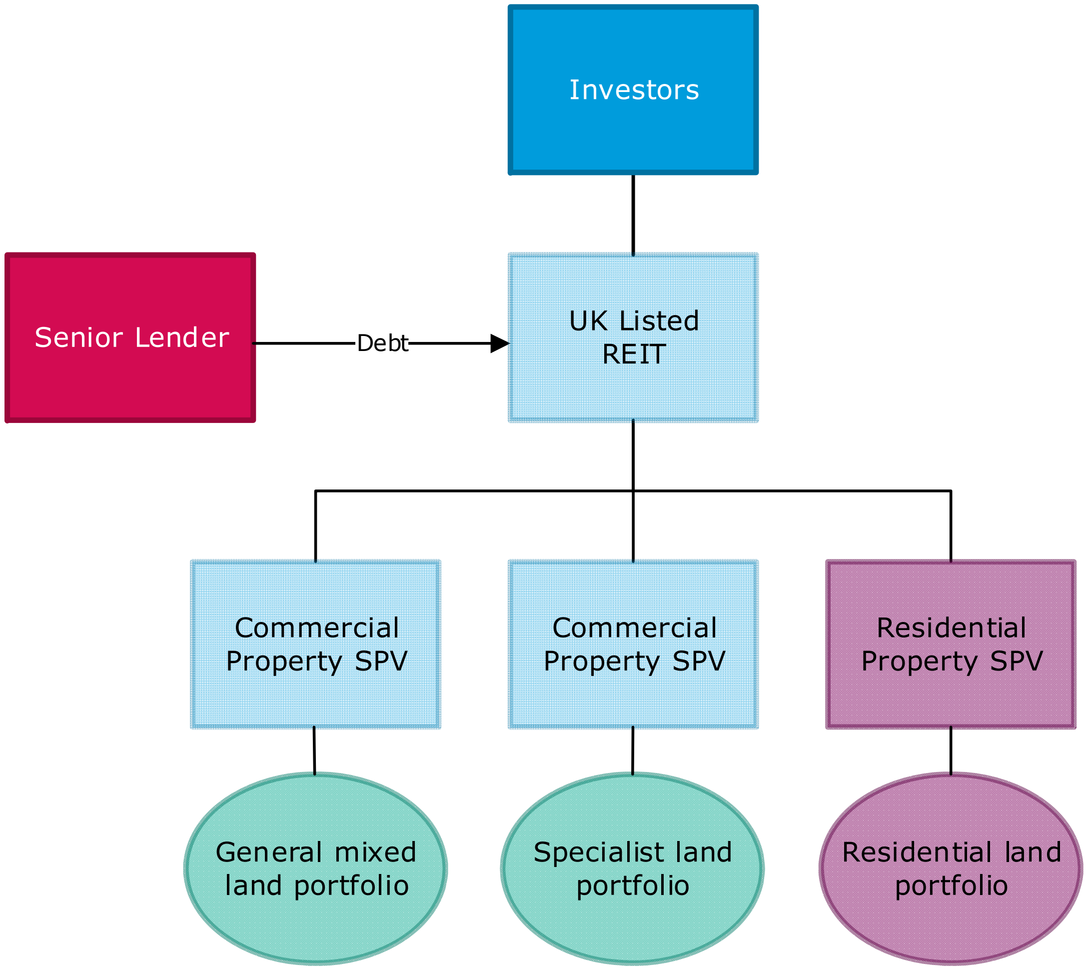
UK REIT



Significant features.

- Can either be a single UK tax resident company or a group of companies of which the parent is UK tax resident
- Must be listed or traded on a Recognised Stock Exchange
- Accounts and constitution of the REIT are publicly available.
- Property investment income and gains (including on property SPVs) exempt from taxation
- Requirement to distribute 90% of property income; effectively converts gains into income
- Profits from development and non-property activities remain subject to UK corporation tax
- Restriction on leverage
- Property income dividends are taxed as if rentals and subject to withholding tax (at 20%) unless exemption applies
- Must block dividends to excessive (10%) shareholders – easily circumvented
- No special exemption from SDLT on land acquisitions

Planning

- Good for large portfolios and wide investor base who want liquidity
- Potential use as a "private REIT" for institutions
- May have advantage as buyer of property owning SPV with a latent gain
- SPVs can be sold at 0.5% SD with rebased gains

UK taxation of real estate – entities compared

Entity	Income	Gains	Effective SDLT wrapper?	Comment
Partnership	△	△	✗	Good for tax exempt investors and family investors but beware SDLT. Consider combining with a corporate blocker
Company	🟥	🟥	✓	Good for non-exempt investors where the investments are not suitable for a widely held exempt fund. Less suitable for exempt investors unless structured as REIT or with exemption election
JPUT elected transparent	△	△	✓	Good for exempt investors but all must consent so may not be practical where widely held
JPUT elected exempt	△	🟩	✓	Good for widely held fund but consider using feeder company if investors do not want to be immediately taxable on income
OEIC/Company elected exempt	🟥	🟩	✓	Good for reinvestment but beware of (i) income taxation in entity and/or (ii) requirement to distribute income. NB Cannot make transparency election as not transparent for income
JPUT non-elected	△	🟥	✓	No election available if JPUT is not property rich. Good for tax exempt investors
Contractual scheme	△	△	✗	Good for tax exempt investors but beware SDLT
Foundation				Not suitable for holding UK real estate due to uncertainty over UK tax treatment but excellent for holding other assets

KEY

△ Transparent

🟥 Blocker – taxable

🟩 Blocker – exempt

Is it still worth using offshore structures?

Summary

It depends!

Some factors

- UK companies are simple and give access to tax treaties
- UK funds can be tax exempt (eg REIT, authorised unit trust/oeic) or transparent; but offshore funds can be structured with similar benefits using the exemption and transparency elections
- UK tax resident holdcos and subs can enable tax-efficient roll-up and reinvestment of income and sometimes gains without triggering anti-avoidance “look-through” rules applicable to offshore structures
- Get best of both worlds: offshore incorporated UK tax resident companies; or offshore holdco with UK sub
- No IHT on shares/debt in offshore company unless residential property
- SD/SDLT benefits by selling non-UK shares/units
- No VAT on many services to offshore establishments
- Less regulation offshore and a bit more expensive and inconvenient to maintain structure

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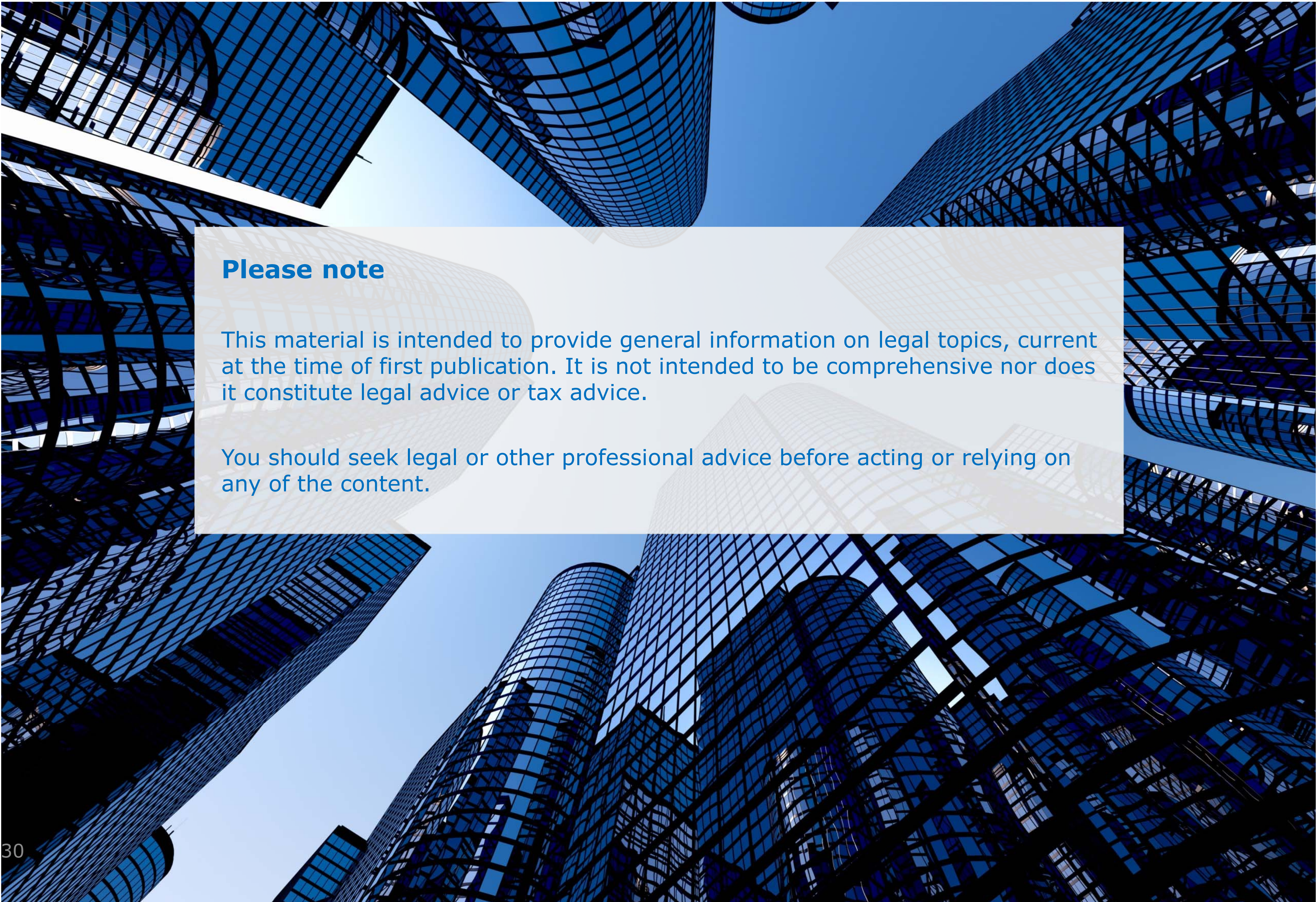

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