Tax in a Time of Uncertainty

Jonathan Evans
Director
Deloitte

In 2016, most people in the UK have been distracted by the referendum on whether to stay in the EU and its aftermath. For tax practitioners, and those interested in the real estate industry, there have been a number of other distractions, namely a raft of tax changes and proposals which would, if enacted, have a profound impact on the way real estate is held, managed, and taxed in the UK. This article will highlight and discuss the most significant of these, namely the UK's reaction to BEPS actions 4 and 7, and consultations on updating and broadening our participation exemption and on increasing the transparency of UK property ownership.

For many years the tax climate for investment, particularly from overseas, into UK real estate has been relatively benign. Such investors paid a rate of tax on rental income lower than corporate tax rates, after being able to deduct arm's length finance costs and some items of depreciation. Profit on the sale of the investments was exempt from UK tax. Acquisition taxes were modest by international standards and there were no annual wealth taxes levied on property other than very low rates of local tax. Over the last five years this climate has changed completely, and is much more complex and unsettled, particularly for residential property. The table opposite highlights the main changes for residential real estate.

The UK government has been a leading player in progressing the BEPS agenda, and is firmly committed to implement the agenda in full.

Residential Property Tax Changes

01. Transfer taxes have increased from a top rate of 5 percent in 2010 to 15 percent now.
02. From 1 April 2016, an additional transfer tax of 3 percent applies to the purchase of second homes and many buy-to-let properties.
03. From 2013, residential properties held through a corporate wrapper (other than for business purposes) are subject to an annual charge ranging from £3,500 for properties worth more than £500,000 to £218,200 for those worth more than £20 million.
04. Such companies, whether UK resident or not, are now subject to UK capital gains tax at a rate of 28 percent on sales of the property.
05. From 2015, non-residents are generally subject to UK capital gains tax on sales of residential property that are not their main residence. This does not apply to diversely held vehicles such as listed companies and many funds.
06. Individual landlords will have their tax relief restricted to 20 percent of interest costs associated with their rental business.
07. From April 2017, non-domiciled individuals will no longer be able to shelter their UK property assets from UK estate duty at rates of up to 40 percent by holding such property through a non-UK company.

These changes, although motivated by a tax avoidance and political agenda, have had a direct impact on institutional and fund investors and have also induced changes to the way commercial property is taxed. This year, for example, the rates of transfer tax on commercial property acquisitions and leases have finally been increased after years of increases only to the rates for residential property. When budgets are under pressure, these changes show that property taxes are a good way to raise revenue in an age of mobile work and capital.

In addition, of course, the UK government has been a leading player in progressing the BEPS agenda, and is firmly committed to implement the agenda in full. It has already drafted provisions to enact the anti-hybrid work as a result of Action 2; these rules will take effect from 1 April 2017.

Anti-Hybrid Rules

01. Rules are effective for payments (and quasi-payments) on or after 1 January 2017.
02. Their objective is to counteract mismatches generated by hybrid instruments, entities, and transfers and certain permanent establishments.
03. Mismatches include timing mismatches.
04. The counteraction varies but typically involves a denial of UK deductions, or an imputation of additional UK income.
05. Mismatches can be imported into the UK through offshore investment structures that have hybrid instruments or entities within them that are not counteracted in the foreign jurisdiction.

It also appears that the Revenue found the rules unsatisfactory, because in March they announced that all offshore developers and traders in UK land would be subject to UK corporation tax without the need for a UK PE.

Interest Restrictions

The Business Tax Roadmap, published on 16 March 2016, set out the government's proposals for introducing a restriction on the tax deductibility of corporate interest expense. The restriction will apply from **1 April 2017**.

The proposals are subject to a consultation process that ended on 4 August 2016[1]. The key elements are as follows (broadly consistent with recommendations of the OECD's BEPS Action 4):

Fixed Ratio
Limiting corporation tax deductions for net tax-interest expense to 30 percent of UK tax-EBITDA (with a de minimis threshold of £2 million).

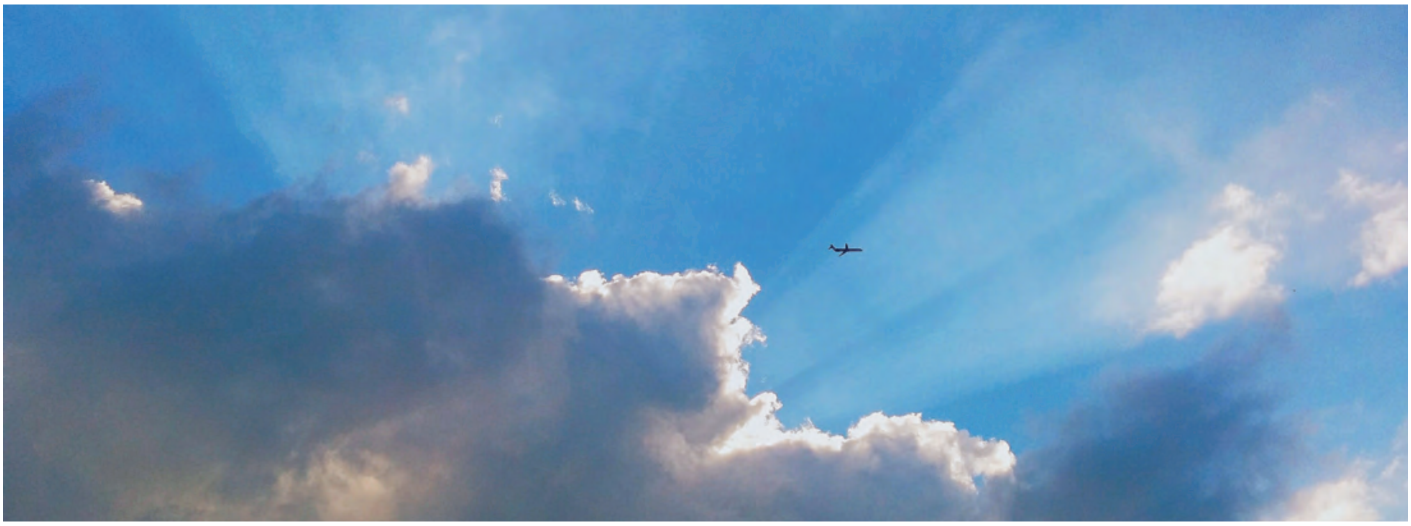
Group Ratio Rule
Calculated as the ratio of net qualifying group-interest expense to group-EBITDA. Insofar as this ratio is greater than 30 percent, this greater ratio would, optionally, override the 30 percent fixed ratio rule.

Modified Debt Cap
Restriction of the overall UK interest deductions to the group's net interest expense—so it would restrict a group below the 30 percent fixed ratio if appropriate.

Industry exclusion
Limited rules intended to prevent the restriction from impeding the provision of private finance for public infrastructure projects in the UK and other specific tax regimes.

Volatility
Rules addressing volatility in earnings and interest (e.g., carry forward of interest restrictions and spare capacity).

1 Tax deductibility of corporate interest expense: consultation on detailed policy design and implementation, HM Treasury, HM Revenue & Customs, May 2016.



The real estate industry has taken a keen interest in these proposals, because as a capital intensive industry with higher levels of gearing, the concern is that if these rules are not drafted properly they will unnecessarily increase tax costs and affect the contribution made to the economy as a whole. The main issues identified for real estate are as follows:

- The proposed rules will not ensure that genuine third party interest costs for a group are deductible In particular, the group ratio is based on accounting concepts of profit, and therefore includes items such as unrealized gains and losses. Those items can produce a much reduced ratio when compared to interest costs for the group as a whole. In addition, for widely diversified groups such as funds that will invest in a number of asset classes, the ratio will even out debt levels on different asset classes, thereby reducing the availability of deductions for assets such as real estate, where the levels of gearing are higher for commercial reasons.
- There is not yet clarity as to whether the rules will apply to non-UK investors in real estate and if so when such investors are not subject to UK corporation tax but only UK income tax. This measure is phrased as a corporation tax measure, but the government has raised the question of whether the rules should be extended to non-resident landlords. Given that some 25 percent of all investors into UK real estate fall into this category, this is a key issue. The hope is that the government will at least delay the application of these rules to such investors.
- Related party interest is excluded from the group ratio, which will mean many funds and joint ventures where the parties borrow and lend down into the structure are restricted to a deduction capped at 30 percent of UK taxable profits.
- For UK REITs, the main issue is to what extent the rules will affect their ability to comply with their mandatory distribution requirement. It is hoped that they will be given some flexibility to manage the impact of these proposals.
- For fund groups, the definition of what constitutes a group is a key issue with the current proposals requiring a corporate parent, meaning that funds constituted as partnerships or other non-corporates will not constitute a single group for these purposes.
- The industry is actively discussing these issues with the government. They are also being urged to introduce some grandfathering for existing debt, and to take more time to introduce the proposals that will constitute a major change to the UK corporation tax system.

Avoiding a UK PE

In response to BEPS Action 7, the UK government introduced the Diverted Profits Tax last year at a higher rate of 25 percent. While this was primarily aimed at digital, IT, and internet-based businesses, the government confirmed at the last minute that it would also apply to real estate structures—in particular, development structures where the property owner and developer were based offshore and did not have a taxable presence in the UK for corporation tax purposes. The new rules have created a lot of uncertainty for these structures, which has largely affected residential developments.

It also appears that the Revenue found the rules unsatisfactory, because in March they announced that all offshore developers and traders in UK land would be subject to UK corporation tax without the need for a UK PE. Although there was a brief consultation on some aspects of the rules[2], the legislation was published on 5 July as the rules came into effect. In some major respects they go further than seems necessary and in particular call into question whether the exemption from UK capital gains tax for offshore investors still applied where one of the main purposes of the investment is to realize a profit on sale rather than being the sole or main object. Discussions with the Revenue and a ministerial statement have indicated that the rules should not affect investment in UK property. This is welcome, but it appears we will have to wait and rely on Revenue guidance when applying these new rules.

It is clear that sales of interests in offshore property companies where the property has been developed are now much more likely to be taxable in the UK. Under the old rules, such sales could be taxable but were often protected by a tax treaty; the government has now agreed on amendments with the Channel Islands and the Isle of Man to ensure that treaty protection for holding companies based in those jurisdictions is no longer is available. We understand that other treaties are being renegotiated.

2 Profits from Trading in and Developing UK Land, HM Revenue & Customs, Technical Note, 16 March 2016.

Transparency of Ownership

The new charges to sales of offshore companies holding UK property will be difficult for the UK authorities to monitor, but a non-tax proposal arising out of the work on anti-corruption may prove to be a key tool. In March, a paper on beneficial ownership transparency was published[3], which proposed that a register of beneficial ownership should be established for all UK real estate.

This proposal follows from the introduction of a register of people with significant control for all UK registered companies and LLPs earlier this year, as well as the EU 4th Money Laundering Directive. As with those proposals, the register would need to record all individuals or entities with significant control over the registered owner of the land. "Significant" here means 25 percent of the shares, voting rights, or the right to appoint a majority of the board of directors. For real estate, the new owner would not be able to be registered as the owner of the land without providing the required beneficial ownership information. If, as suggested, the register also applies to the 100,000 or so foreign companies already registered as owning UK land, then it could prevent those companies from dealing with their UK land holdings. This is potentially a radical change to the land ownership rules in the UK, but would also provide a useful back up for the new tax changes discussed above.

A Reformed Participation Exemption

The final proposal on the reform of the UK participation exemption (called the Substantial Shareholder Exemption) was issued in May[4]. This is currently focused narrowly on groups that carry on active trading activities, and is not available for funds and passive investments. It is therefore not available to UK REITs, which can suffer corporation tax on the sale of investment subsidiaries. The government recognizes, however, that this encourages funds and others to establish offshore holding vehicles.

The UK has a number of features that are attractive to headquarters or holding companies activities, such as a comprehensive dividend exemption, an extensive tax treaty network, the absence of withholding tax on dividends, a broadly territorial regime for taxing UK company profits, and low (and falling) tax rates. However, the consultation considers whether the current exemption should be widened to increase the UK's attractiveness as a holding company location. The consultation also raises the possibility that the exemption could be available to investment groups, although whether it would be available for the sale of shares in a purely passive property holding company is doubtful. For funds, the Government wants to consider whether there is a case for reform of the exemption targeted toward the funds sector, which could benefit funds with significant exempt investors, such as sovereign wealth and pension funds. UK REITs could also benefit if the exemption is made available to them.

Conclusion

This article has highlighted just four of the current changes that could affect the UK real estate and fund sectors. All of these pre-date the referendum vote to leave the EU, however, and Brexit now adds an additional layer of uncertainty to these proposals. With a new government in place, it already appears that there may be a change of direction on issues such as the budget deficit and an even greater desire to make the UK open for business. Ideally, this would mean a rethink or delay on proposals such as the interest restrictions, but encourage a widening of our participation exemption. It is likely that we will not know more before the end of the year when the new chancellor gives his Autumn Statement on 23 November. What does seem certain is that the tax landscape for real estate investment and funds in the UK will continue to change. One beneficiary of these changes may be the UK REIT, which, as an increasingly flexible and substantially tax exempt vehicle, may prove to be a more popular channel for foreign investment into UK real estate.

3 Beneficial Ownership Transparency, Department for Business Innovation and Skills, March 2016.
4 Reform of the Substantial Shareholdings Exemption: Consultation, HM Treasury, May 2016.