MACFARLANES

PROPERTY TAX UPDATE

The UK tax landscape is currently undergoing major changes, many of which will affect the real estate industry. This note summarises some of the key recent developments relevant to real estate investors and developers.

INTEREST BARRIER AND EXTENSION OF CORPORATION TAX

- From 1 April 2017, many UK-based property groups will suffer restrictions on the tax relief they can claim in respect of their loan finance. Historically there has generally been no limit to tax relief that can be claimed, subject to connected party debt being on arm's length terms, and the use of shareholder and intra-group financing has been a valuable tool in the tax-efficient structuring of property investment and development. Under the new rules, broadly, the corporation tax deduction UK companies can claim for finance costs will be capped at the higher of £2m and 30 per cent of its adjusted UK EBITDA (in some cases the cap will be higher, where a group's third party finance costs are higher as a proportion to the worldwide group's EBITDA).

- There will be an exemption from the new rules for some commercial landlords. In response to extensive lobbying from the real estate industry, the Government has announced its intention to extend the exemption for "public benefit infrastructure" activities to some commercial letting. It is unclear at this stage exactly what criteria will need to be met to qualify for the exemption, and there is a concern that the rules will be too tightly drawn for many to benefit. However this may be a useful exclusion for the industry, sparing companies that qualify from the additional compliance burden that this new regime will bring.

- The Government has also proposed the extension of the scope of corporation tax to non-UK resident companies which receive taxable income from the UK, such as rental income from UK land. This change will affect the large number of investors who hold their UK real estate assets offshore (Jersey and Luxembourg being among the most popular jurisdictions).

- The stated desire here is to "deliver equal tax treatment" of UK resident and non-resident vehicles. On the plus side, it will reduce the headline rate of tax for offshore landlords' rental income in line with the UK corporation tax rate (which will reduce to 19 per cent for the financial year 2017 and to 17 per cent for the financial year 2020), and may enable greater flexibility to use losses within a group. However it will also mean the application of the new interest barrier rules to offshore landlords, resulting in a potential restriction to their deductible finance costs. There has been no suggestion that this extension of corporation tax will apply to capital gains of offshore property companies, although this could be seen as the logical next step towards ensuring equal treatment of resident and non-resident investors.

- No date has been given for the implementation of this measure, and with the Government's consultation only beginning at Budget 2017 it seems unlikely that this change will take effect before April 2018.

LOSSES

New rules on tax losses also come into effect on 1 April 2017. The rules will:

- provide more flexibility on the types of profit that can be relieved by losses; but

- restrict the amount of losses which can be carried forward. In effect, companies with annual profits in excess of £5m will only be able to use losses from earlier periods to shelter 50 per cent of the excess.

- This cap on the use of carried forward losses will impact on developers who typically incur losses in the early years of a project and realise a significant profit on practical completion. In response to concerns that the new rules could lead to developers being taxed on more than their economic profit, the Government have provided the ability for developers to carry back unused losses over the final three years of trading. However this will not always assist, particularly where a development trade continues for more than three years after practical completion due to the time it takes to sell all the completed units.

- With the proposed extension of the scope of corporation tax to non-UK resident companies, offshore landlords are likely to be affected by these rules too.

NEW RULES FOR UK PROPERTY DEVELOPERS

- Last year saw the introduction of new rules which extend the scope of UK tax on the profits of developing UK land. Previously it was possible to use offshore structures to shelter development profits from UK tax. Developers could use companies based in Jersey, Guernsey and the Isle of Man to carry out residential developments, and take advantage of the outdated double tax treaties the UK had with those jurisdictions to shelter profits from tax,

or alternatively set up offshore companies to carry out commercial developments, sheltering tax on the profit by selling the company rather than the completed property.

- Under the new rules, which took effect for disposals of land on and after 5 July 2016, the scope of corporation tax has been extended so that in broad terms all profits of UK development will be taxed regardless of where the developer is based and how they have structured the development. The UK's double tax treaties with Jersey, Guernsey and the Isle of Man have also been amended to ensure that developers cannot use vehicles based in these jurisdictions to escape UK tax.

- There are also specific rules taxing profits realised by related parties which have made a contribution (financial or otherwise) to the development (the anti-fragmentation rule). These rules will apply to UK based developers as well as offshore ones, and will in some cases prevent the use of shareholder financing to reduce taxable profits.

- The new rules replace historic anti-avoidance rules, but have a wider scope. In particular the old rules applied where a person acquired property with the "sole or main object" of realising a gain on disposal, whereas the new rules apply if realising a gain is merely "one of the main purposes" of an acquisition. This change has given rise to concerns that the new rules could apply to property investors as well as developers and traders, bringing offshore groups within the scope of UK tax on the sale of their commercial property investments.

- HMRC in their guidance have stressed that the new rules will not be applied to genuine investment transactions. Ultimately, the taxation of genuine investment activity should be unchanged by these rules, while for residential developers using Jersey companies this represents the final nail in the coffin following the introduction of the diverted profits tax (also known as the "Google" tax) in April 2015.

- It will still be possible to sell developments by selling the company holding the completed property (and there will often be a significant SDLT saving in doing so), however where companies are set up to hold property developments long term, care must be taken to ensure the company's investment intentions are reflected in all relevant acquisition documentation.

OFFSHORE PROPERTY DEVELOPERS TASKFORCE

- HMRC have established a taskforce targeting developments that used offshore structures (usually based in Jersey, Guernsey or the Isle of Man) where no or minimal UK corporation tax was paid on residential development profits.

- It may have been hoped that with the introduction of new rules for property developers (see above) HMRC's appetite for challenging historic developments would be reduced. However they have made it clear that they have significant resources to challenge developments carried out prior to the change and a wide remit to pursue any offshore development structure where tax may have been saved.

- Any challenge to an offshore structure is likely to be on the basis that the developer company had a "permanent establishment" in the UK, to which profits can be attributed and taxed accordingly. HMRC's chances of success will depend to a large extent on how the tax structuring has been implemented in practice, and they will investigate how the development was carried out on the ground and the role of onshore development managers. In addition HMRC have said that they will also scrutinise other tax aspects of the structuring including any VAT and stamp duty land tax planning.

- Challenges by the taskforce will be made under "Code of Practice 8", a framework for enquiring into arrangements where HMRC consider that there is a significant loss of tax. Under this framework HMRC have broad powers to demand information, including from group companies or third parties, and can also take steps to recover tax even where a company has been dissolved.

- We have met with the leader of the taskforce who made it clear that they will leave no stone unturned in pursuing developers where there may have been a loss of tax, including by way of VAT or SDLT planning. Any developer who has used offshore or tax planning structures in the past should expect to be contacted by the taskforce and should prepare accordingly. As always, it is best to seek legal advice at an early stage!

SDLT RATES

- There have been a number of changes to the rates of SDLT over the last couple of years: not only have the standard rates changed, and separate regimes been introduced for Scotland (from 1 April 2015) and Wales (from 1 April 2018) as part of the devolution of taxing rights, but new categories for additional residential properties and high-value residential property transactions have also been introduced. The regime for residential acquisitions is now more complicated than ever, and the top rates for high value properties (up to 15%) appear to be having a material impact on the market.

- The most recent of these changes was the introduction of the 3% surcharge for residential transactions, applicable to all corporate purchasers, and individuals acquiring a second residential property except in limited circumstances where they are replacing their main residence.

- The rules are complex, and there are various traps for the unwary. Disappointingly there is no exemption from the 3% surcharge for institutional investors, although "multiple dwellings relief" is still available to reduce the applicable SDLT rate, and the purchase of six or more units in a single transaction can still benefit from the (lower) rates applicable to commercial property.

- It remains to be seen whether 2017 will see more amendments to the SDLT regime, but with residential property remaining a political hot topic, further changes cannot be ruled out.

Please let us know if you would like to discuss any of the above with us in more detail.

CONTACT DETAILS

If you would like further information or specific advice please contact:

KIRSTEN PRICHARD JONES
SENIOR COUNSEL
TAX
DD +44 (0)20 7849 2613
kirsten.prichardjones@macfarlanes.com

SARAH SHUCKSMITH
SOLICITOR
TAX
DD +44 (0)20 7849 2292
sarah.shucksmith@macfarlanes.com

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MACFARLANES LLP
20 CURSITOR STREET LONDON EC4A 1LT

T +44 (0)20 7831 9222 F +44 (0)20 7831 9607 DX 138 Chancery Lane www.macfarlanes.com

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