NEW TAX FOR OFFSHORE INVESTORS

UK Government proposes to tax gains on sales of UK property or UK property companies by offshore investors

Budget changes

Offshore investors may become subject to UK tax on gains made on UK commercial property, if the UK government's proposed changes to real estate taxation in the Budget on 22 November are taken up. These include a significant increase in UK tax charged on offshore investors in UK property – currently rental income from UK investment property is taxed in the UK wherever the investor is, but capital gains on the sale of UK commercial property generally are not subject to UK tax if the investor is non-resident. If the changes (which will be the subject of consultation) are introduced then from April 2019 UK tax would be charged on such gains wherever the seller is resident, whether it sells the property directly or sells an entity that owns the property. Corporate sellers would be subject to UK corporation tax, currently at 19% but expected to reduce to 17% in April 2020.

This is a material change in the tax position for overseas investors, though it does follow a recent theme of government trying to collect more tax from the UK real estate sector generally. Concern has already been raised that it may have implications for the flow of new capital to the UK, and representations will undoubtedly be made to government along those lines.

Although strictly the Budget announced a consultation in this area rather than a definite proposal, it seems likely that something similar to this will be enacted in due course. As a result, we have already started to see proposed acquisitions being affected by the announcement.

Background

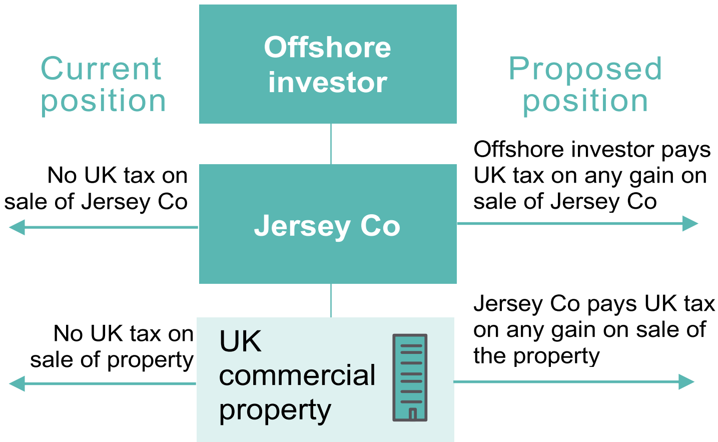
Until recently, capital gains arising to a seller were only taxed in the UK if the seller was UK tax resident (or was a UK branch of a non-resident trading in the UK with that asset). For example, an overseas investor could set up a Jersey company to invest in UK commercial property, maintain Jersey Co offshore, hold it for 10 years and then sell (either by Jersey Co selling the property or by the investor selling Jersey Co) without paying UK tax.

That position has gradually changed – capital gains tax for some non-residents selling UK residential property was introduced in 2015, and there is a complex interaction with other taxes on sales of residential properties. In addition, since 2016 traders and developers of UK property (residential or commercial) have generally been taxed in the UK on their profits, irrespective of where they are resident or whether they have a UK branch.

The change announced in the recent Budget is similar to the 2016 change for traders and developers, but is aimed at overseas entities investing longer term in UK real estate rather than trading in it.

What are the changes, and what are the implications?

The policy announced on 22 November was that a non-resident investor in UK property (commercial or residential) will in future pay UK tax on gains arising from a sale of that property. This applies whether the property is disposed of directly or indirectly (for example, by way of share sale of a property-holding SPV).



Under the new proposals sellers would generally calculate the gain on disposal using the property value at April 2019 as their tax acquisition cost, if they acquired the property before that date. In other words, there would be a rebasing to market value at that date so that gains accrued up to that point are not taxed. If this would produce an unfair result, in some cases the investor will have the option of calculating the gain using its actual acquisition cost. For corporate sellers the relevant tax will be corporation tax, currently at 19% but expected to fall to 17% in April 2020. So, in a very simple case where property was acquired in 2016 for £80m and is then sold in (say) 2022 for £150m and there is no material capex on the building during that time period:

Purchase price	£80,000,000
Property value April 2019	£120,000,000
Sale price	£150,000,000
Taxable gain	£30,000,000
Tax (assume at 17%)	£5,100,000

The rules are more complex where the sale of the property is indirect – e.g. is a sale of a property-owning SPV, not of the property itself. Broadly speaking, if the entity sold derives at least 75% of its gross asset value from UK real estate (tested at the point of sale, not acquisition) and the seller together with associates owns at least a 25% ownership interest in the entity sold, then the result will be similar to a direct property sale though there are some differences in how the taxable gain is calculated. In working out whether the 75% test is met, the rules will allow for tracing value through chains of subsidiaries, trusts etc.

Although this represents a significant change in how the UK taxes gains arising from sales of UK property, it does reflect the balance of taxing rights under international treaties. Most of the UK's double tax treaties give the UK the right to tax gains on UK real estate even if they arise to non-residents, though not all currently cover gains on indirect disposals. It is worth being clear that this new policy covers not just "offshore" investors in the sense of investors who choose to use a jurisdiction such as Jersey, Guernsey or the BVI – the changes will apply to all overseas investors whichever jurisdiction they are resident in.

In practical terms, this announcement means that overseas investors now looking to invest in UK real estate should when modelling their potential returns assume that UK tax will apply to capital gains they make from that investment as well as to rental income.

What happens next?

The consultation announced at the Budget contains a lot of detailed proposals for changes in law, but no actual legislation. As noted above, it seems likely that something similar to these proposals will be implemented in due course, but that there will be a considerable amount of lobbying and representations about the detailed design of the changes. One key area that will need to be focussed on is the treatment of institutional investors. The Budget papers state there will be a targeted exemption for institutions, and that exemptions from UK tax deriving from something other than residence will continue to apply. The detail on this will be important.

In addition, concerns have already been raised by the British Property Federation that the new tax will mean less capital investment in the UK from overseas investors, and we have already seen commercial property acquisitions by such investors be affected by the announcement. We expect ongoing developments in this area to be monitored closely by real estate sector participants.

As regards market reaction at this stage only speculation is possible, but potential outcomes include a decline in popularity of indirect property transactions after 2019 (due to latent gains inside SPVs that will not benefit from further re-basing after that date), and a rise in the use of tax-exempt vehicles like REITs. The impact on the attractiveness of UK real estate to overseas capital is of course a material unknown factor at this stage.

Addleshaw Goddard intends to publish updates on this topic as it develops.

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