



Real Estate

Overseas investors in UK property An introduction to the tax implications

Tax issues are often a key factor when investing in UK Property, many of which are summarised below. The Real Estate team at Nabarro include specialist property tax lawyers experienced in guiding clients through the myriad of tax considerations that often arise.

SUMMARY

Rental income arising to a UK branch or agency of a corporate overseas investor, from a property held in the UK, will be subject to **corporation tax** at a rate of 30%.

If rental income is received by an overseas investor which does not have a branch or agency, this income is subject to income tax at the basic rate of 22%.

The amount of corporation tax or income tax payable on rental income will reduce if the taxable income is reduced. There are a number of ways of achieving this which are explored below.

Capital gains on a property held in the UK by an overseas investor are generally not subject to corporation tax in the UK unless:

- the property is held as part of the UK branch or agency of that overseas investor; or
- the transaction is caught by the anti-avoidance provisions detailed below.



In addition, there are usually provisions under **double tax treaties** which prevent the income from property being subject to both income or corporation tax in the UK and in the country of residence of the overseas investor. This may mean that the investor may not be subject to UK income or corporation tax at all, depending on the precise terms of the double tax treaty.

UK VAT will arise on expenses relating to the property, and possibly on the acquisition of the property itself. However, it is likely that this will be recoverable if the measures detailed below are taken.

Stamp Duty Land Tax is payable on the acquisition of property. This was introduced for land transactions taking place after 1 December 2003. It is a modern, self-assessed tax based on transactions, with the buyer paying generally 4% on the purchase price plus any VAT.

RATES OF CORPORATION TAX AND INCOME TAX

As the small companies' rate of corporation tax does not apply to non-resident companies, the rate of corporation tax applicable will be 30%.

If the overseas investor is liable to income tax instead of corporation tax, the rate of tax is 22%.

LIABILITY TO WITHHOLDING TAX

Where a property is owned by an overseas investor, there are provisions stating that the tenants or managing agent of the property are liable to account to the Inland Revenue for withholding tax which is deducted from the rent due to the overseas investor. However, it is possible to apply to the relevant division of the Inland Revenue for these provisions to be disapplied, provided certain criteria are met. It is important that such an application is made to the Inland Revenue as early as possible so that rental income may be paid without tax deduction.

DEDUCTIONS FROM TAXABLE INCOME

An overseas investor will be liable to corporation tax or income tax on the taxable income, being the rental income less deductible expenses.

From a corporation tax and income tax perspective, it is advantageous for as many deductions as possible to be made from the taxable income.

The main deductions which may be made are as follows:

- capital allowances claims; and
- interest on a loan taken out to acquire the property.

As these can have a substantial effect on the amount of corporation tax or income tax paid, they are discussed in some depth below.

CAPITAL ALLOWANCES CLAIMS

The Capital Allowances Act 2001 allows a certain amount to be deducted from profits each year to allow for depreciation on certain assets. In the context of property, claims may be allowed against:

- the building itself, depending on the type of building; or
- plant and machinery which are attached to the building ("fixtures").

For a building itself (as opposed to the plant and machinery attached to it) to be eligible for capital allowances claims, it must be "industrial", for example a factory or a warehouse. Buildings such as offices and retail premises are excluded from the definition of "industrial" but the plant and machinery attached to them would usually qualify for allowances.

The Capital Allowances Act 2001 allows a certain amount to be deducted from profits each year to allow for depreciation on certain assets.

Broadly speaking, the rate of depreciation for tax purposes allowed per year is, for industrial buildings, 4% of the cost of the building and for fixtures, 25% (on a reducing basis).

Where an overseas investor only owns a single property and that property is sold, if the amount of allowances claimed exceed the amount by which property or fixtures have depreciated, a balancing charge will arise. This amount must be repaid to the Inland Revenue. Conversely, if the amount for which the property or fixtures are sold is less than the amount of depreciation on the property or fixtures, the amount of allowances which have effectively been underclaimed can be deducted from the rental income.

CAPITAL ALLOWANCES - POOLING PROVISIONS

The pooling provisions introduced by Finance Act 1997 tend to spread the tax effect of the sale of a single property out of a portfolio. Under the pre-1997 rules, each property was treated as a separate asset so that the sale of that asset would trigger an immediate balancing allowance or balancing charge.

Now, where a number of properties are held, they are all pooled together so that the disposal proceeds merely flow into the pool, the balance of which forms the basis for the calculation of the writing down allowance for that accounting period. The exception to this is where the sale of the building constitutes, or is otherwise coincident with, the cessation of the entire property letting business.

Most sales of buildings now allow for both parties to elect for the amount of the consideration to be apportioned to the fixtures in the building under Section 198 Capital Allowances Act 2001. Such an election must be notified to the Inland Revenue.

The election must be made within two years of the acquisition of the interest in the fixtures, and the notice must accompany the tax return of the relevant party. The election is irrevocable once made.

The election is available even if the purchaser is a non-taxpayer (e.g. a gross pension fund), and it will often form part of the commercial negotiations for the amount of consideration apportioned to the fixtures to be zero. In these circumstances it may be prudent to specify a consideration of £1, as the relevant sections refer to an "amount", and it might be (zealously) argued that nil consideration is not an amount but instead an absence of an amount.

The interest on a loan taken out to acquire a property is allowed as a deduction against taxable income from the property.

However, where the vendor (rather than the purchaser) is a non-taxpayer, then the election mechanism is not available because it is not the case that “a disposal value of a fixture is required to be brought into account by the former owner”. It is commercially important that this is identified during the purchaser’s preliminary enquires. Where an election is available, the amount cannot be greater than the lower of:

- the price being paid for the building; and
- the vendor’s original qualifying expenditure on the plant.

INTEREST ON LOANS

The interest on a loan taken out to acquire a property is allowed as a deduction against taxable income from the property. However, there are critical transfer pricing provisions which seek to prevent taxpayers reducing their UK tax bills by undercharging or overcharging, in an appropriate case, for supplies made to or by related persons. These provisions are particularly relevant if an overseas company, for example, buys land in the UK and takes a loan from a related person in order to maximise interest to offset against the taxable UK rent.

The transfer pricing provisions apply where a provision (“the actual provision”) has been made between two persons (“the affected persons”) by means of a transaction or series of transactions and, at the time when the actual provision is made, one of the affected persons was directly or indirectly participating in the management, control or capital of the other or the same person or persons was or were directly or indirectly participating in the management, control or capital of each of the affected person. Thus if A Limited in Jersey lends monies to its 100% subsidiary in Jersey, B Limited,

the loan would be the making of a provision by means of a transaction - the actual provision - and A Limited and B Limited would be the affected persons. The rules would apply because A Limited directly participates in the capital of B Limited and B Limited would be eligible to offset the interest against its UK rental income.

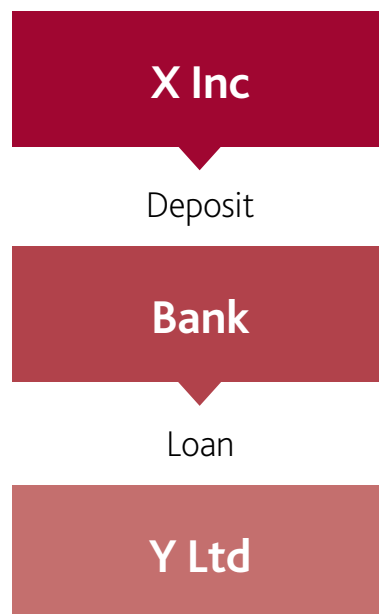
If the actual provision differs from the provision which would have been made had the parties been independent enterprises (“the arm’s length provision”) and this confers a potential advantage in relation to UK taxation on one of the affected parties, or, (whether or not the same advantage) on each of them, then the rules will apply.

The effect of the rules is that the profits and losses of “the potentially advantaged person” are computed for tax purposes as if the arm’s length provision had been made or imposed instead of the actual provision. “Transaction” has a very wide meaning and includes non-legally binding undertakings and mutual practices and a series of transactions. The legislation is sufficiently stringent to ensure that these provisions apply to cover situations not only where the actual provision would have been different, but also where no provision at all would have been made between independent parties.

Situations covered include:

- a sale of land at an undervalue;
- an intra-group loan where the terms of the loan or the position of the borrower is such that the loan would not have been made had the parties been at arm’s length. For example where:
 - the rate of interest is either higher or lower than it would have been had the parties been at arm’s length; or
 - the debt to equity ratio of the borrower is such that an arm’s length lender would only make the loan on onerous terms or would not have made the loan at all;

- “Back-to-back” situations where for example, X Inc deposits £1m overseas with a bank which lends £1m to X Inc’s Jersey subsidiary Y Ltd.



CAPITAL GAINS

A gain realised on the disposal of UK real estate is exempt from UK capital gains tax where it is realised by a person who is neither resident nor ordinarily resident in the UK (Section 2 TCGA 1992). However, the following issues must be borne in mind:

- If the profit is realised by a trading transaction rather than an investment transaction, so that it is Schedule D Case I income rather than a capital gain, then UK income tax or corporation tax may be chargeable on the profit.
- If the capital gain arises from certain types of land transaction then there may be a Schedule D Case VI charge under the provisions of Section 776 TA 1988. This is legislation which was introduced to stop taxpayers from structuring their affairs to take advantage of situations where it is more beneficial from a tax perspective if a capital gain is realised than if a charge to corporation tax or income tax arises. Basically, to be caught by the legislation, the land must be:
 - purchased with the sole or main intention of making a capital gain on its resale; or
 - used as trading stock (as opposed to being used as an investment asset); or

- purchased and developed with the sole or main intention of making a capital gain on its resale.
- Broadly speaking, the section is aimed at persons trying to recharacterise trading stock as capital assets. It is therefore unlikely to apply where a property is held with the intention of obtaining rental income and is then sold on for purely commercial reasons.
- If a non-resident person carries on a trade in the UK through a branch or agency and the capital gain accrues on the disposal of UK land used in or for the purpose of the trade, or used or held for the purposes of a branch or acquired for use by or for the purposes of the branch, then the gain may be chargeable to capital gain tax or corporation tax under the provisions of Section 10 TCGA 1992.

DOUBLE TAX TREATIES

Where a profit is derived by person resident in a country which enjoys a double tax treaty with the UK, then treaty relief from UK tax may be available. The exact wording of the particular treaty in question needs to be carefully scrutinised as the crucial provisions vary in each case. Generally, the treaty will protect residents of the treaty state from taxation in the UK in certain circumstances. "Business profits" are usually protected unless they derive from a "permanent establishment" located in the UK. "Other income" derived from the UK is usually protected from UK tax.

Treaty protection requires the party obtaining protection to be a resident of the treaty state. This is differently defined in the various treaties and not all collective investment schemes qualify.

VAT

Generally the supply of land is exempt for VAT purposes. As this potentially restricts input tax recovery for the person making the supply of land, it is possible to choose to charge VAT on the supply. This "opting to tax" or "electing to waive exemption" means that VAT incurred on the costs of making the supply of land (e.g. VAT on conveyancing fees), will generally be recoverable.

Opting to tax involves:

- making a decision that VAT will be charged on any income received by the investor from the property; and
- notifying that decision (within 30 days of making the decision), to HM Customs and Excise ("Customs").

If the seller or lessor has themselves opted to tax the property, VAT will be payable on the consideration paid to acquire the property and, if applicable, on rental payments to the lessor. Alternatively, if the property is less than 3 years old, and the freehold of the property is bought, VAT will be payable. Again, this VAT should be recoverable provided the investor has opted to tax the land.

To recover the VAT, the overseas investor will have to register for VAT in the UK. Either the investor can appoint an agent to deal with its VAT affairs in the UK or it can register with a particular branch of Customs and can deal with its VAT affairs from overseas.

The option to tax can be ineffective in certain circumstances. Those which are most notable are where a transaction is caught by the complex anti-avoidance legislation relating to options to tax. A common example of where this applies is where the tenant is not in a position to recover some or all of the VAT charged to it by the landlord, such as where it is a financial institution, and it pays the landlord to do major works to the building. If this occurs, the landlord cannot charge VAT on the rent because the option to tax is disapplied. This will mean that the landlord itself cannot recover VAT on the expenses it has incurred on the building.

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STAMP DUTY LAND TAX

Stamp duty land tax is payable by the purchaser on the acquisition of a property interest at the following rates:

- where the consideration for the sale is between £60,000 and £250,000, the rate is 1%;
- where the consideration for the sale is between £250,000 and £500,000, the rate is 3%; and
- where the consideration for the sale is more than £500,000, the rate is 4%.

Where a building is leased, stamp duty land tax is payable by the tenant on the premium at the same rates as above. Stamp duty land tax is also payable in general by the tenant on 1% of the discounted cash flow of the rent payable under the lease, at a 3% discount rate.

The stamp duty land tax paid is not recoverable and is therefore an absolute cost.



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