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# Alert | Real Estate Tax

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# UK Real Estate: New UK Tax Landscape for International Investors

Over the last few years, the UK tax rules for overseas investors in UK real estate have seen dramatic changes. In this GT Alert, we highlight some of the changes and some of the steps that may be considered to potentially mitigate their impact. In navigating these changes, what has become clear is the importance of having the right structure in place to suit the particular investor(s).

Now is the time to take action, whether it be reviewing existing structures to make sure that they are still fit for purpose, considering whether pre-sale planning steps should be taken to minimise the potential for a price chip by a future buyer or considering the best structure to use for a new investment.

## What has changed? Introduction of NRGCT

On 1 April 2019, the UK introduced Non-Resident Capital Gains Tax (NRCGT). Prior to the introduction of NRCGT, non-UK residents were not generally subject to UK tax on capital gains arising from investments in UK real estate, except for residential property in some cases. From 1 April 2019, gains realised by an overseas investor on the disposal of UK real estate assets are subject to UK tax. The rate of tax depends on whether the overseas investor is a company for UK tax purposes (in which case the rate of tax is 19%) or an individual (in which case the rate of tax is generally 20%). In addition, gains realised on a disposal of certain interests in "UK land rich" vehicles (i.e. a company or other vehicle deriving at least 75% of its gross value from UK real estate) are also now subject to UK tax if the overseas investor (together with connected persons) has a "substantial indirect interest".

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*What should you do? Benefit from an exemption if you hold less than a 25% investment*

An overseas investor will generally have a "substantial indirect interest" in a UK land rich vehicle for the purposes of NRCGT if at any time in the period of two years ending with the disposal, the investor (together with connected persons) has held a 25% or more investment in the vehicle. This is tested by reference to: (a) voting power, (b) entitlement to proceeds on a disposal of equity, (c) entitlement to income distributions and (d) entitlement to proceeds on a winding up.

This exemption may be useful for joint ventures and Family Offices as, depending on the circumstances, it may be possible to structure an investment through the use of unconnected entities which each hold less than a 25% interest. Care needs to be taken, however, as this exemption is not available where the overseas investor holds their investment through a structure which has a defined connection with certain "collective investment vehicles" (CIVs). Consequently, where it is proposed to take advantage of this exemption, it will be important to avoid incorporating certain CIVs, such as limited partnerships, unit trusts and companies with certain characteristics, in the wrong place in the structure.

*What should you do? Seek to benefit from the value of an operating business*

If investing in a real estate asset together with an operating business carried on at the property, such as data centres, hotels, care homes or certain student accommodation, where possible overseas investors should seek to structure the investment so that the vehicle disposed of derives less than 75% of its value from UK land and, consequently, a disposal of the vehicle falls outside of NRCGT and is not subject to UK tax.

*What should you do? Consider making a fund exemption election*

The NRCGT rules introduce a new tax exemption election regime for funds and other CIVs that meet certain conditions. Qualifying CIVs can make an election which enables their share of gains realised on the disposal of UK real estate assets and UK land rich vehicles to be exempt from UK tax.

Where an exemption election is made, each time an underlying disposal is made investors in the CIV are treated for UK tax purposes as making a deemed disposal and re-acquisition of their interest in the CIV at market value. Although some investors, such as sovereign wealth funds and qualifying pension funds and charities, will be exempt from UK tax on such deemed disposals, taxable investors (including non-UK investors which are subject to UK tax on capital gains) would be subject to UK tax on such gains (at rates of 19% for companies and generally 20% for individuals). However, it is generally possible to defer the payment of such UK tax for up to three years.

*What should you do? Resist price chips for UK tax on inherent gains*

If a buyer is proposing to acquire a UK land rich company or other vehicle, and the market value of the property (or shares in a property holding company) exceeds its tax base cost, then the buyer may seek a price reduction to reflect the UK tax charge that will arise in the future when this gain is realised. In view of the exemption election regime outlined above, many funds and other CIVs can now effectively achieve a tax-free step-up in the base cost of UK real estate assets. The way this is achieved is not wholly straight-forward, and sellers should be aware of how this benefit can be achieved by a buyer so that they can resist price chips. It is also important that buyers are aware of this so that they can be competitive when seeking to acquire UK real estate.

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### What has changed? Corporation tax on rent

Overseas investors have generally structured their investments to include significant levels of investor debt so that they can use interest and other finance costs to shelter UK rental income profits from UK tax. On 6 April 2020, the UK moved non-UK tax resident companies investing in UK real estate into the UK corporation tax regime (from the UK income tax regime), potentially resulting in significantly more UK tax being paid by these companies on UK rental income profits.

The main consequence of this change is that these companies are now subject to certain rules restricting UK tax deductions for finance costs, including the corporate interest restriction rules that, broadly, limit tax deductions for third-party and related-party finance costs to 30% of EBITDA or, if higher, £2 million per annum, per defined corporate group. In addition, they are subject to rules that limit tax deductions for finance costs where certain hybrid entities or instruments are used and rules that limit the ability to utilise carried forward surplus expenses and losses.

*What should you do? Navigate the new world of restrictions on finance costs*

In respect of assets with a gross value of up to circa £40 million, it may be possible to structure the investment so that the property-holding entity does not form part of a wider corporate group and can obtain tax deductions for finance costs of up to £2 million per annum. In many cases, this will eliminate the impact of the corporate interest restriction rules mentioned above. For higher value assets, depending on the mix of investors, it may be possible to take other steps to structure investments (and in certain cases re-structure existing investments) to mitigate the effect of the restriction on tax deductions for finance costs.

### What has changed? More difficult to buy UK real estate free of UK transfer tax

Due to a potential UK transfer tax saving of circa 5% of the price in most cases, there is an advantage of buying a company or other vehicle owning UK real estate rather than buying the underlying real estate asset(s). Sellers often need to take steps pre-sale to ensure that their structure facilitates a corporate sale. However, as a result of a recent court case, the potential UK transfer tax saving may be lost in some cases if a seller undertakes these steps after a buyer has come on to the scene.

*What should you do? Early pre-sale planning*

Sellers should be reviewing their structures and taking any steps that may help facilitate an onward sale of a company or other vehicle owning UK real estate earlier than they would have done previously and, in particular, prior to going to market or otherwise engaging with potential buyers. By doing this, sellers can preserve the potential UK transfer tax benefit for buyers and secure a higher price to reflect this.

* *This GT Alert is limited to non-U.S. matters and law.*

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