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Memorandum

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The UK's new property tax regime for non-UK residents: a simple tool kit for investors

The UK's new regime introducing a charge to UK tax on non-UK residents' investment gains from UK commercial real estate is unfortunately complex, making it difficult for investors to understand the practical impact on any particular existing or proposed holding structure. However, although the regime is not yet even in force and its impact on the market still in process, it is possible to suggest some basic rules of thumb which may be helpful in starting an analysis.

For our previous coverage of the new regime, click here and here.

The new regime – difficulty of multiple layers of tax

Generally speaking a principal difficulty with the new rules is that, by making any non-UK resident entity with a direct or indirect interest in UK real estate potentially chargeable to UK tax on gains on that interest, structures commonly used to hold UK real estate investments can now give rise to multiple charges to UK tax on the same gain. (There could be tax on a property holding entity and also tax on an investor in that entity.) Tax exempt investors can also be indirectly subjected to tax as a result of holding UK real estate indirectly, through entities which are now taxable on gains.

This risk of multiple layers of tax means that acquisition structures should be carefully planned, and it may be worth considering a restructuring of existing investments. The best approach will vary depending upon the nature of the ultimate investor and, where a property is already held in an investment structure, the form of that structure. Counterintuitively, in some cases the problem of layers of tax may in fact be best addressed by multiple tiers of ownership. Some simplified common examples follow.

Private Equity Real Estate Fund

Taking a basic case of a real estate fund in limited partnership form, it appears likely to be beneficial for the fund to:

- establish a corporate holding entity exclusively for UK real estate investment ("Holdco"), which could be UK or non-UK tax resident;
- Holdco could then be used to hold UK property indirectly through property-specific companies or offshore unit trusts such as JPUTs ("SPVs"), whether acquired as existing property owning entities or newly established to acquire real estate directly.

Provided the fund is eligible to make a collective investment vehicle ("CIV") "exemption" election in relation to Holdco, then:

- Holdco may be able to dispose of the SPVs in future without UK tax;

- importantly, each SPV may benefit from a market value uplift in UK tax basis in the underlying property on that sale (so a future buyer could not argue for a price discount justified by low historic tax basis in the SPV); and
- the SPV could also be sold without a charge to stamp duty land tax ("SDLT"), under current law at least.

Investors would then be taxed on any gain as and when the proceeds were returned to them, giving a single charge to tax for taxable investors and allowing exempt investors in the fund to benefit from that status.

The ability for the fund to make the exemption election, which does however carry a compliance burden, is critical, and would seem to give eligible funds an advantage over ineligible funds which would not be able to structure similarly. Existing and planned funds need to consider eligibility urgently. This may depend, amongst other factors, on a genuine diversity of ownership test requiring open marketing within the targeted class of investor.

Non-UK Retirement Benefit Fund

It may be possible for non-UK retirement benefit funds, many of which may benefit from a UK capital gains tax (but not income tax) exemption, to implement a "captive" version of the exempt Holdco / SPV structure available to funds. They could then potentially protect the benefit of their own exemption by using investment vehicles which would themselves be exempt on gains, holding property through SPVs which could (currently) be sold without SDLT and which could enjoy a tax basis uplift on sale.

That outcome would depend upon the investor establishing a Holdco to make investments into UK real estate which would itself be eligible for a CIV "exemption" election. Although the Holdco would not appear to be a "collective" investment vehicle, this may in fact be possible due to the status of the investor, a retirement benefit scheme, as a "qualifying investor". Conditions would need to be met of course - amongst other requirements the Holdco would need to be established as a non-UK tax exempt entity or in a tax free jurisdiction, and it would need generally to correspond to the OECD's definition of a REIT (distributing its income annually etc.). The UK compliance burden of establishing such an exempt Holdco (including increased reporting obligations) may be justified by the favourable tax treatment then available.

"Double exempts" – sovereign investors and UK retirement benefit funds

For this category of investors, exempt from UK tax on both capital gains and rental income, the need to preserve the benefit of their rental income exemption suggests a different approach. Offshore unit trusts such as the common Jersey Property Unit Trust ("JPUT") may be attractive here. It may now be possible to combine a JPUT's existing income tax transparency with elective capital gains tax transparency under the new regime. That would enable a double exempt to hold UK property in a form which protects the benefits of its wide tax exemption whilst enabling a future sale of the underlying property indirectly through a sale of JPUT units without SDLT. Partnerships may achieve similar direct tax results but without the SDLT advantage.

A more expensive alternative, where values justify, could be the use of a private REIT, which would enjoy a capital gains and income tax exemption of its own.

The potential attractiveness of a JPUT structure to double exempts may make the use of JPUTs advantageous to other investors (such as real estate funds establishing property holding SPVs) if they have an eye to future marketability.

Joint Ventures

The Holdco / SPV structure discussed above appears likely to be suitable for use in joint venture situations where the SPV is not 100% owned, as the benefits should be available within SPVs held at least 40% by an exempt Holdco (albeit proportionately applied). Similar joint venture rules apply to investments by UK REITs, making the structure potentially suitable for use in JVs with that sector. UK REITs may favour corporate SPVs over JPUT SPVs as the JPUT approach would not give the basis uplift benefit on a sale by a REIT.

Conclusion

There are of course many potential fact patterns, and all situations must be examined carefully based on their own circumstances with consideration given to the full extent of the new rules (including for example the trading asset exemption). Where the more efficient structures contemplated above are not available, other approaches may be possible to reduce the risks of a double charge.

Although the new regime is not yet in force, it is not too early to review its likely future impact on existing and proposed investments. The regime is complex, but using the basic building blocks within the legislation a tax efficient outcome should typically be possible.

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