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A Guide to Structuring UK Property Developments

Introduction

When considering investing in a property development project in the UK, as well as legal and financing considerations, it is important to take tax advice to ensure that the development is structured so as to achieve maximum tax efficiency. Advice should be taken before the structure or joint venture is agreed; changing the structure at a later date may give rise to additional tax liabilities.

Various tax issues will arise depending on the specific nature of the project. Factors that can affect tax liabilities include:

- The nature of the site, e.g. whether it is development land, or whether there are existing properties.
- Whether the intention is to develop the site for immediate resale or to retain some or all of the developed properties for investment purposes.
- If property will be retained for investment purposes, whether it is to be for commercial or residential use.
- For existing buildings, whether a change of use is envisaged, e.g. from commercial to residential lettings.
- The size of the project and the parties involved in the transactions.

Trading Activity or Investment Activity?

The tax treatment on disposal of a UK property will differ depending on whether the activity is considered to be a trading activity or an investment activity.

a) Trading Profits

Recent anti-avoidance legislation (known as the 'Transactions in Land' legislation) expands the scope of the UK tax charge on profits arising from transactions involving dealing in or developing UK land, regardless of the residence of the company or individual carrying out the development, or whether that company or individual is trading in the UK through a permanent establishment.

The new legislation ensures that profits from trading in or developing UK land are always subject to UK tax. In the past, it was possible (although often disputed by HMRC) for overseas developers to avoid UK tax on such profits by carrying out their activities through a structure located in a suitable tax treaty jurisdiction, such as Jersey, Guernsey or the Isle of Man, and claiming relief under the treaty to avoid UK tax. Amendments have been made to the tax treaties in question to ensure that relief is no longer available and that the UK has the relevant taxing rights in relation to UK land.

Prior to the introduction of these new rules, a non-resident company was chargeable to UK corporation tax only to the extent that the profits were attributable to a UK Permanent Establishment (PE). In

certain circumstances where a PE was artificially avoided, profits arising on UK land development activities carried out by large corporations may have been charged to the Diverted Profits Tax (DPT) at 25%. However, following the introduction of the new rules on transactions in land that extend the scope of UK corporation tax to non-resident companies trading in UK land regardless of whether a PE exists in the UK, the DPT is likely to have less impact on UK real estate transactions.

Anti-fragmentation

The new legislation also contains anti-fragmentation rules that apply whether or not there is a UK tax avoidance purpose. These rules cover situations where profits from a UK development activity are shared between associated persons acting together, such that a portion of those profits are taken outside the scope of UK tax.

For example, these rules would apply to most situations involving the use of a connected overseas entity that contributes services or finance to the development company, in return for a share of the profits on disposal. Where certain conditions are met, payments to the connected entity will not be deductible in calculating the profits of the trade that are chargeable to UK tax, with the result that the entire development profits are taxable in the UK.

Professional advice should be taken to determine the impact of these rules in the specific circumstances of each case.

b) Investment Activity

The Transactions in Land rules can apply where a main purpose of acquiring the land is to realise a profit on disposal. At first sight, it might appear that all property developments would fall within the ambit of this legislation, as it is rare that an investment in UK property would be made with no expectation of realising a gain on sale. However, HMRC guidance confirms that the rules are not intended to re-characterise investment activities, and do not apply to transactions such as buying or repairing a property for the purpose of earning rental income, or as an investment to generate rental income and enjoy capital appreciation.

Profits arising on the disposal of an investment property by a non-UK resident are chargeable to either:

- ATED-CGT (for properties worth over £500,000 that are within the scope of ATED (Annual Tax on Enveloped Dwellings)) where the disposal is by a company or other ‘non-natural person’; or
- Non-resident capital gains tax (NRCGT) where the disposal is made by a non-resident individual or a non-resident company not within the charge to ATED.

ATED-CGT applies to the portion of the gain arising after 6 April 2013 and the rate is 28%.

NRCGT applies to the portion of the gain arising since 6 April 2015. The rate of NRCGT for individuals, trustees and partners is 18% to the extent that the gain falls within the taxpayer's basic rate band and 28% on the excess. For corporate entities, the rate is currently 20%.

Change of Intention – Appropriation to or from trading stock

In the case where an existing site which has been held for investment and the owner decides to redevelop the site prior to sale, there is a deemed capital disposal at the point of the change of intention, and the property is appropriated to trading stock. The gain should be calculated based on the market value of the land at the time of appropriation, and the deemed disposal may give rise to a tax charge. However, an election can be made to reduce the chargeable gain to zero, rolling the gain over into the opening value of the trading stock.

On eventual sale of the redeveloped site, profits will be assessed to income tax (if held by individuals, partners in a partnership or trustees) or corporation tax (if held by a company) as trading profits rather than as a capital gain. Only the profits relating to the period after the change of intention should be taxed as trading profits. The portion relating to the period where there was an investment intention should not be included in the tax calculation (unless a rollover election was made).

The apportionment between the two periods should be made on a just and reasonable basis. What is just and reasonable will vary depending on the facts of the case. The requirement to register for UK corporation tax arises at the point that a trading intention is formed.

When a property is appropriated from trading stock, to be held as a capital asset, this gives rise to a deemed disposal at market value, which is taxed under the Transactions in UK Land rules. The profit arising will be chargeable to income or corporation tax depending on the status of the owner.

Finance

Financing arrangements can have a significant impact on tax liabilities and therefore need to be given careful consideration at the outset, specifically with regards to:

- Whether there is a requirement to withhold tax on interest payments made to a non-UK resident person and, if so, whether there is a mechanism to reduce the rate of withholding tax.
- Transfer pricing requirements.
- Restrictions on interest deductibility, such as:
    - Wholly and exclusively rules
    - Unallowable purpose rules
    - UK Debt Cap
    - Rules governing profit-participation loans.

VAT recovery

The VAT position will depend on a number of factors. The extent to which VAT can be recovered on build costs is an important consideration as it will have a direct and significant impact on profit. The

main points to consider are:

- The supply of new residential buildings is zero-rated for VAT purposes, provided the supply is made by a person constructing or converting the building. In the majority of cases, developers will have this status. This entitles the developer to recover VAT on the costs they incur. In such circumstances it may be possible for a subcontractor to zero rate their own supplies of building services and materials to the developer.

- The sale or lease of a commercial property is generally exempt from VAT, and so there is no VAT recovery on costs, unless an 'option to tax' has been made by the owner. If an option to tax is in place, the sale or rentals will be subject to VAT and this will allow VAT recovery on costs. An option to tax must be notified to HMRC in writing and is generally irrevocable.

- The sale of 'new' commercial buildings (less than three years old) is generally standard rated, although there are certain exceptions.

- A reduced rate of 5% may apply to certain property conversions, e.g. from commercial to residential use.

- Residential lettings are VAT exempt and so there is no VAT recovery on costs.

VAT is a complex area and mistakes can be costly. Verfides can provide advice on all VAT issues in respect of the acquisition, development and sale of property. Where appropriate we can arrange applications to HMRC to "opt to tax" a commercial or mixed use building in order for input VAT to be reclaimed.

Construction Industry Scheme (CIS)

The CIS is an HMRC tax collection mechanism applying to the construction industry. It requires contractors to check the CIS status of their sub-contractors before making payments to them. Depending on the CIS status of the subcontractor, the contractor may be directed by HMRC to withhold tax from payments to the subcontractor and pay it over to HMRC on account of the subcontractor's final tax liability.

If subcontractors are to be taken on, the contractor (which may be a sole trader, partnership or company) will need to register with HMRC for CIS and file monthly returns. Each time a subcontractor is engaged, the Contractor will need to contact HMRC to check the subcontractor's CIS status and whether it needs to make withholdings.

A developer may be both a subcontractor (of a UK Company) and a Contractor (of other sub-contractors). If so, the developer will need to register and complete returns as both contractor and subcontractor.

The same CIS rules apply to businesses based outside the UK, if construction work as a contractor or

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subcontractor is carried out in the UK.

Failing to register as a contractor or to make timely returns to HMRC can result in significant penalties.

Summary

When considering investing in UK land or property developments, it is essential that UK tax advice is taken at the earliest opportunity to determine the optimum structure, which will depend on the specific circumstances and intentions of the developer. All relevant taxes will need to be considered, as well as anti-avoidance legislation.

Consideration will need to be given to the nature of the development, who the parties involved in the development are, whether the intention is for immediate resale or to retain the properties for investment purposes, and if the latter, whether the properties are to be residential or commercial lets.

Verfides can assist with all aspects of tax planning in relation to UK land and property developments. We can also assist with all relevant compliance obligations to ensure all forms and returns are filed on a timely basis.

This document has been prepared as a general guide and it is based on the latest legislation and case law. Whilst every care has been taken in its preparation, Verfides cannot accept any responsibility for any person relying on this publication. Professional advice should be obtained before undertaking transactions and Verfides will be pleased to provide such advice where appropriate.