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Taxation of investment in UK commercial real estate

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The UK tax regime applicable to non-UK investors in commercial real estate continues to be relatively generous. The transaction tax on a property acquisition is low as is the effective rate of tax on gains realised on a property's disposal.

Typical structure

Most UK commercial property investments are made through a non-UK company acting as a special purpose vehicle. This is a tax efficient form which offers flexibility in terms of future disposal routes when an investor wishes to exit the investment. Investment into a UK commercial property through a non-UK company eliminates any exposure to UK inheritance tax.

Capital gains

Capital gains on commercial property made by non-UK investors were not, traditionally, taxed in the UK. This position will change in April 2019. From that date, capital gains on direct or indirect disposals of UK land will be taxable. There will be an exemption for investors who have a stake of less than 25% in a property-owning company or partnership. The rate of tax is set to be 19%.

Income

Income derived from the property by a non-UK resident company will, from April 2019, be subject to tax at a rate of 19%. This tax may be subject to a 'withholding' regime which means that the tenant or other paying entity must deduct the tax due and account for it directly to the tax authority, HM Revenue & Customs ('HMRC'). In most cases, the holding company or other owning entity will register under HMRC's 'non-resident landlord scheme' which will allow it to receive income gross, deduct expenses, calculate taxable profits, and submit a UK tax return in the usual way.

Gearing

Deductible expenses for tax purposes can include interest charges on borrowing and so gearing will generally result in tax- efficiency as well as amplification of investment performance. Although there are provisions that may limit the full deductibility of interest, many investors introduce borrowing in order to achieve this result.

Capital allowances

It is not unusual for the seller's 'capital allowances' to be transferred, in whole or part, to the buyer. These are 'writing down' allowances against taxable profits in respect of historic capital investment in plant and machinery. The allowances are at the rate of 18% a year, with an 8% rate applying to 'integral features', and generally have effect on a 'reducing balance' basis. Each year the allowance is applied to the balance of expenditure after deduction of previous years' allowances, for example the 18% allowance is applied to 100% of the qualifying expenditure in the first year but to only 82% of the expenditure in the following year and so on. This means that around 75% of the expenditure is 'written down' over the first seven years.

On the sale of a property, the seller may well wish to retain any unused capital allowances. However, where the buyer would be able to benefit from them more than the seller, it may make more commercial sense for the seller to pass them to the buyer, generally for additional consideration.

Stamp duty land tax ('SDLT')

SDLT on the acquisition of commercial and mixed use property is charged at the following rates:

Property transfer value: SDLT rate
Up to £150,000 – Zero
The next £100,000 (the portion from £150,0001 to £250,000) - 2%
The remaining amount (the portion above £250,000) – 5%

SDLT is payable by the buyer.

SDLT will be payable within 30 days after 'substantial performance' of the transaction, which is usually completion.

SDLT is only applicable on land transactions. If a property transaction is structured by way of a share sale, no SDLT will be applicable.

Value added tax ('VAT')

VAT at 20% may be charged on the purchase price of commercial or mixed-use properties. This will be the case with new buildings and those where the seller has 'opted to tax'. In cases where the sale is subject to VAT, there will be little practical alternative other than to 'opt to tax'. That will often have the effect of making the sale itself VAT-free (and consequently mitigating the SDLT payable).

Where there is no immediate need to opt to tax, you should consider the best strategy for the property as a whole, taking into account future expenditure plans and the likely tenant-mix profile as some tenants will not be able to recover the VAT paid on rent.

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