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Hot property: why investors are focusing on the US

03 JANUARY 2018

CATEGORY:
ARTICLE

Relevant event: Where in the world | 22 May | 9.00am – 5.30pm

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US residential and commercial property has taken on a new allure for real estate investors, with both coasts attracting international funds as a result of the Trump administration's reform of the US tax system.

The tax reforms have dramatically changed the tax liability for property investors, putting the US on a more level playing field in relation to other real estate markets. The new rules also mean that there are now a wider range of effective ways to hold real estate investments, and investors with an existing portfolio of US properties are also advised to review their holding structures to make sure they remain efficient.

The US tax changes mean the US has chosen to put itself on more of a level playing field in relation to tax when compared with other sophisticated and liquid real estate markets. This comes about because of the reduction in the federal tax rates applicable to both corporations and pass-through entities. The US federal corporate income tax rate has been reduced to a flat 21% from rates graduated to 35%. The US federal income tax rate on income earned through pass-through entities (such as partnerships) now benefits from a 20% deduction, which results in a 29.6% maximum effective rate, based on the 37% individual and trust federal income tax rate. There are of course other changes relating to the deductibility of expenses which will affect the way property investments will be made and affect residential versus commercial real estate differently. There will still be exposure to US estate tax when individuals holding US real estate investments but for non-US individuals it will be possible to put in place structures to mitigate or eliminate that exposure.

The UK is choosing a different path but one which aligns its tax rules relating to the ownership of UK commercial real estate to those of other major economies. The legislation, which has been outlined in a consultative document issued by the UK government after the UK budget in 2017, and which contemplates the legislation being effective from April 2019 would subject investment gains on commercial real estate owned by non UK residents to tax rates of 28% for individuals and 19% for companies and widely held funds. The rules will also apply to tax gains arising on the disposal of interests in entities which are “property rich”. This marks a fundamental shift where investment gains on UK commercial property realised by non UK residents, which are currently not subject to UK tax. The UK government has decided go down a similar path to that which it has done in respect of gains on residential property owned by non UK residents which have been taxable as from April 2015. The ownership of UK residential property is also subject to UK inheritance tax whether owned in a structure or not. The consultation document which has been issued makes no mention of extending UK inheritance tax to commercial real estate owned by non UK residents through structures but the risk of that happening cannot be ruled out, albeit that US citizens investing in UK real estate through structures that are subject to Estate Tax, are exempted in any event. It should be stressed that the issuing of a consultative document does not mean the suggested changes will necessarily become law, although there is a strong presumption that these changes will be introduced.

It may be too early to gauge the impact of these tax changes to the behavior of international investors and in particular those from low tax jurisdictions. However these investors need to be aware of the changes and how they might impact their global commercial real estate investment strategy. Investors will also need to consider how the structures on existing investments in these jurisdictions might need to be changed and what strategies should be adopted albeit the UK changes are only in the process of consultation.

Withers are monitoring these changes in both the US and the UK and are publishing detailed notes on the tax changes. The combination of our real estate and tax teams means that we are well placed to advice on the practical steps to take now and as they come in to play.

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