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Real Estate Tax Changes

What should be on your radar?

February 2021

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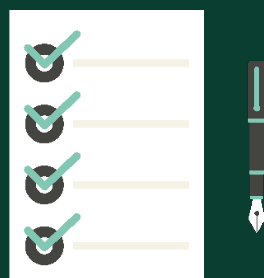
Introduction

Whilst the Covid-19 pandemic and the UK's relationship with the EU post-Brexit have dominated the recent political and economic agenda, there are a number of important tax developments that those in the real estate sector should have on their radar for 2021.

This briefing includes an overview of the key (non-Covid specific) tax changes for the sector that have recently been implemented or are coming down the track in the next few months, plus a summary of some potentially significant future developments for both direct and indirect real estate investments. We comment on what these developments mean for the real estate world and on some steps that those affected should think about taking.

How we can help



As one of the largest teams of tax lawyers in the City, we advise on all tax issues relating to real estate. We are currently advising clients on the matters identified in this briefing, and, through our membership of industry bodies and government working parties, are also involved in many of the new developments referred to here.

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Follow us on LinkedIn for updates from Travers Smith Tax.

Real Estate ("Bricks and Mortar") Tax

Tax change	Introduction	What does this mean for the real estate sector?
Introduction of 2% SDLT non-resident surcharge for residential property	For transactions with an effective date on or after 1 April 2021, a new 2% SDLT surcharge will apply (subject to transitional rules) to most acquisitions of a major interest in one or more dwellings where one or more purchasers is "non-resident". The 2% surcharge will apply in addition to the normal residential SDLT rates, including the 3% surcharge on acquisitions of additional dwellings and dwellings purchased by companies, and the 15% SDLT charge for acquisitions of higher threshold interests by non-natural persons. Exemptions and reliefs will generally apply as normal. As regards determining residence, there is a brand-new test for individuals, complex provisions for companies and special rules for particular purchases and transactions. In addition to companies that are not UK resident for corporation tax purposes, the new rules also treat as non-resident companies that are UK resident if, broadly, they are close companies and under the control of non-resident participators. Importantly there is no exclusion for offshore funds or build to rent developers. This may negatively impact the viability of developments.	Quite apart from the increased SDLT costs – the highest marginal rate is now 17% – the new rules add yet more complexity to the SDLT provisions relating to residential property, which have already become increasingly tricky to apply in recent years. For example, where the purchaser is a UK company, the analysis to determine whether the "close" company and non-UK control tests are met will often be complex, making life harder for advisers and thereby increasing costs for taxpayers. Importantly there is no exclusion for offshore funds or build to rent developers. The new rules also catch off-plan sales, which are popular with offshore buyers. This may negatively impact the viability of developments. There is some comfort to be found in the fact that non-resident purchasers of six or more separate dwellings under the same transaction, or purchasers under mixed transactions, will still pay SDLT by reference to the non-residential rates (and, therefore, will not be subject to the sucharge). Also, where the conditions are met, a multiple dwellings relief claim is possible, although whether it is worth making will depend on the facts.
Introduction of domestic VAT reverse charge for certain construction services from 1 March 2021	The VAT reverse charge on construction services will switch the responsibility for accounting to HMRC for VAT on certain supplies made on or after 1 March 2021 (irrespective of the date of the contract) from the supplier to the customer. Subject to certain exceptions, the new rules will apply to (1) supplies of "construction services" (virtually identical to the construction industry scheme concept of "construction operations"); and (2) certain supplies of other services and goods which fall to be treated as part of a single supply of services that includes construction services. There are three key exceptions to the rules: 1. supplies in respect of which a payment does not need to be included in a CIS return; 2. supplies to "end users" (i.e., businesses that do not make onward supplies of the construction services supplied to them); and 3. supplies to "intermediary suppliers" (i.e., suppliers that receive construction services and on-supply them, without material alteration), where (a) the intermediary supplier is connected to the expected end user or (b) the supplies are in relation to land in which both the intermediary supplier and expected end user have a relevant interest (e.g., a landlord or tenant)).	Businesses should take advice on how these affect them, noting that the new rules apply to supplies made under contracts entered into before (as well as after) 1 March 2021. While, in practice, the reverse charge mechanism is most likely to apply to supplies made by Tier 2 and Tier 3 contractors, it is potentially of wider application. The end user and intermediary supplier exceptions only apply if the recipient notifies its supplier in writing of its status as such. Businesses wishing to rely on these exceptions should therefore make sure they notify their suppliers, and suppliers may wish to ask customers about their intentions within applicable time limits. Suppliers subject to the new rules will need to update their invoicing systems to deal with invoices subject to the reverse charge, and customers in turn will need to update their systems to deal with this. HMRC have helpfully confirmed that they will be taking a "light touch" approach in dealing with errors in the first 6 months provided efforts are made in good faith to comply with the legislation. However, it would be prudent to obtain advice on the correct VAT treatment of affected supplies since the process of correcting errors with HMRC and counterparties can be costly.

VAT on termination fees

On 2 September 2020, HMRC radically changed its published guidance and policy on the VAT treatment of early termination fees and compensation payments paid pursuant to contractual provisions following two EU cases.

Previously, HMRC had generally treated such payments as not constituting a VATable supply, on the basis that they are compensatory in nature. In the guidance, HMRC stated that they are of the view that such payments are normally further consideration for the underlying supply of goods or services for which the tenant/customer originally contracted, even if expressed to be compensation or damages.

Therefore, if the underlying supply under a contract was subject to VAT, such a payment made by the recipient of supply would normally also be subject to VAT. (The position for payments made pursuant to a separate agreement outside the original contact was not impacted by the change – they were already likely to be VATable.)

Unhelpfully, the changes were announced to be retrospective. However, following significant industry lobbying HMRC announced on 25 January that the new VAT treatment will only become effective from a future date and that they would issue further revised guidance in due course (including on how to proceed if taxpayers have already changed how they treat such payments because of the September brief).

The future date has yet to be announced, but is understood likely to be 1 March 2021. In the meantime, HMRC say that businesses can either: (a) continue to treat such payments as further consideration for the contracted supply; or (b) go back to treating them as outside the scope of VAT, if that is how they treated them before.

The change in approach from HMRC is likely to mean that VAT will in the future be payable in respect of early termination fees and compensation payments where there is a direct link between that payment and an underlying taxable supply. For example, a payment by a tenant of a break fee payable under the terms of an opted lease is now likely to be VATable.

It is worth noting that, in a real estate context, there remains a possibility that the underlying supply might not actually be standard rated. If, in the example above, the lease was instead not opted, the supply would still be exempt and no VAT due.

One area where there is continued uncertainty is dilapidations. It has been reported that HMRC are likely to conclude that these payments are VATable (where the landlord has opted). This is on the basis that they are, in essence, further consideration for the underlying supply (rather than being outside the scope as damages for breach of contract). Industry bodies have made representations that this is not how dilapidations work in practice, so the jury is still out on this one while HMRC deliberate further.

Landlords and other potential recipients of affected payments should review contracts and internal operational procedures. They will want to ensure that they have the ability to charge VAT if necessary. Those who have, as a result of the September changes, already altered their practice, should re-visit this issue once the final guidance is issued.

Changes to the construction industry scheme (CIS)

In November, HMRC published draft legislation, to apply from 6 April 2021, to implement various proposed reforms to the CIS rules.

One important change is to the rules for determining whether an entity that does not carry on construction operations as part of its core business is required to operate the CIS (the "deemed contractor" rules).

Currently, businesses are obliged to look back at each year end to determine the average level of construction expenditure over the previous three periods – if that figure exceeds £1 million, the business is required to operate the CIS. The new rules will require the position to be considered on a rolling basis and will bring a business within the CIS if its expenditure in the previous 12-month period exceeds £3 million (subject to a new grace period, which is in HMRC's gift).

Other proposed changes include expanding the scope of the penalty regime and amending the rules on when costs of materials are subject to the CIS (so that they are only excluded where the sub-contractor has directly purchased the materials).

The proposed changes to the deemed contractor rules (which are understood to be intended to stop manipulation of the current look-back rule), would require businesses not currently within the CIS to start monitoring the level of their construction expenditure on an on-going basis, which may involve increased compliance burdens.

Policies on deducting costs of materials should be reviewed in light of the proposed change, which has the potential to impact cash flows.

Multiple Dwellings Relief (MDR) – application of the 3% higher rates for transactions including a non-residential element

Prior to 13 November 2020, HMRC's published position was that the 3% higher rates surcharge for purchases of additional dwellings applied to the residential element of a mixed-use property transaction where a claim for MDR is made.

However, on 13 November 2020, the relevant SDLT guidance (see SDLTM09740) was amended to reflect that HMRC now considers the 3% rates not to apply for these purposes provided that the non-residential element of the transaction is not "negligible or artificially contrived".

The change in guidance is generally good news for taxpayers. However, the "negligible or artificially contrived" caveat is not contained in the legislation itself and may lead to uncertainty for taxpayers, particularly as regards what is "negligible" in these circumstances. Further guidance would be welcome.

Those who overpaid SDLT in the past (either by overpaying on the MDR element or, indeed, not making an MDR claim at all), may want to consider amending their return and making a reclaim, if they are still in time to do so (noting that, generally, such a claim will only be accepted if made within 12 months of the filing date).

Welsh Land Transaction Tax (LTT) and Scottish Land and Buildings Transaction Tax (LBTT) – changes to rates and bands

With effect from 22 December 2020, a number of changes were made to the LTT regime, including:

- all LTT higher residential rates have increased by 1% (taking the highest rate to 16% on the portion of the price above £1.5m); and
- the zero-rate LTT bands for non-residential property lease premiums and rents have increased from £150,000 to £225,000.

On 28 January, the Scottish Government confirmed that for transactions with an effective date from 1 April 2021 onwards, the ceiling of the nil rate band for residential LBTT will return to £145,000.

The temporary increase to the nil rate band of LTT for residential property transactions will end on 31 March 2021.

Taxpayers and advisers should bear in mind these changes for transactions involving Welsh or Scottish real estate.

It also serves as a gentle reminder that the stamp regimes in Wales and in Scotland differ from that in England and Northern Ireland.

Real Estate Funds Tax

Tax change	Introduction	What does this mean for the real estate sector?
UK Fund Review	The government has launched a review of the UK funds regime, covering tax and relevant areas of regulation, with the aim of ensuring that the UK asset management sector remains strong and competitive. As part of this, on 26 January, it announced a very wide ranging "call for input" on how to improve the UK funds regime, with responses due by 20 April. Another aspect of the review is proposals for a new tax privileged asset holding company (AHC) regime and some amendments to the REIT regime, both of which are well under way (see below). In addition, a review of the VAT treatment of fund management fees is expected shortly.	While the UK has introduced new fund structures and updated some older ones suitable for real estate over the last 15 years, it still does not always offer the full range of products that the market may seek, effectively, at times, forcing structures to be established offshore. Proposals to fill in the gaps and do more to assist the growth of related businesses across the UK are, thus, very welcome. Helpfully, the review covers tax and regulation of both existing structures and potential new vehicles. Practical, as well as technical input is needed, with the call for input including a request for identification of any key points that it has not expressly picked up.
New asset holding company (AHC) regime	As part of the wider funds review, the government has launched a consultation on the design of a new, tax-privileged UK AHC regime for alternative fund structures. The aim is that qualifying AHCs (i.e. those which satisfy eligibility criteria (which are still to be determined)) will get generous tax benefits (including, broadly, exemption from tax on gains and tax only on a small profit margin on income). The detail is still being discussed, with the prize of being able to compete internationally (e.g. with Luxembourg) firmly in mind and constantly reiterated. The timetable is short: the consultation ends on 23 February, with the government throwing much resource at it and being very much in listening mode as to what is needed, with many industry discussions taking place. Though final timing is not precise, it is generally expected that the regime would come into force next year.	The introduction of a UK AHC regime, which is simple to understand and operate and, which works for local and international investments across asset classes, would make the UK a much more attractive jurisdiction for holding vehicles in funds and, potentially also, for some other widely held structures. Given the principle of local taxation of real estate, UK real estate is an area giving rise to much discussion. While still to be determined, solutions mooted (albeit not perfect for all) include holdings by the AHC of UK real estate to be through corporates, with a streaming option for UK REITs. The exemption for gains in the AHC from non-UK real estate is welcomed, but the real bonus here would be an exemption from UK tax on overseas rent where property is held directly. This is not yet certain. For more detail on the proposals, please click here.
Changes to the REIT regime	The government is considering changes to the REIT regime in two phases, the first of which, running In parallel with the new AHC regime proposals, considers targeted reforms to the UK REIT rules. The reforms include the option of an unlisted REIT for certain investors, more flexibility of the 75% "balance of business test" and the extension of the list of eligible institutional investors (relevant to the "non-close" requirement) alongside introduction of a widely held rule. For more detail, please click here. The second phase, forming part of the call for input, includes proposals to abolish the interest cover test and amend the 3 year development rule. It is not clear yet whether the proposals around improving the position for international investments will be able to be moved to the first phase, but these too are on the table.	These proposals are very welcome. In particular, the option of an unlisted REIT should facilitate the use of REITs in joint venture and clubs deals and as a vehicle for institutional investment, without the need for the additional costs and administration of listing offshore. We expect, however, to see the listing requirement retained for the regime in relation to the wider market. Other changes mooted should help offer more operational flexibility and would get rid of a few quirks. The introduction of a widely held requirement in the institutional investor rule, may, however, mean that some investors who currently qualify as "institutional investors" may cease to do so.
Long Term Asset Fund	On 9 November 2020 the Chancellor committed to having an LTAF up and running within a year. The LTAF is aimed at alternative, illiquid assets and patient capital, such as real estate and infrastructure, to assist with long-term investment. Whilst the precise form and eligible assets are still being considered, the LTAF would be an open-ended, FCA authorised product, in the form of a non-UCITS retail scheme (NURS). The NURS rules would, however, be adapted for the LTAF, for example, offering more flexibility around redemptions (which could be daily or up to two years). We assume that the LTAF would use existing tax law for the relevant vehicle/regime, but this is to be confirmed and is part of the call for input on funds.	The LTAF would potentially offer another option in the UK real estate fund market, as, while the qualified investor scheme (QIS) already provides something similar for professional investors, the idea is that the LTAF would be suitable for those who prefer or need to invest in NURS products, such as, for example, DC pension funds. It is not anticipated, however, that the direct take-up by retail investors, generally, would be great. Being open-ended and FCA regulated, the LTAF will not satisfy all the outstanding gaps in the UK real estate funds market and, so, we anticipate that the development of the professional investor fund (PIF) (see below) and indeed further developments on the QIS will still be sought alongside.
Professional Investor Fund (PIF)	Aimed at real estate, but capable of holding other assets classes, in contrast to the LTAF, the PIF, as proposed by AREF, would be a closed-ended or a hybrid (but not an open-ended/ FCA authorised) fund and would have the form and tax treatment of the authorised contractual scheme (ACS). However, as an unregulated collective investment scheme, it would be much more flexible (e.g. in terms of redemptions, investment types etc) but, as a corollary, would only be open to professional investors investing at least £1m. From a tax perspective, following the ACS, there should, for example, be no SDLT on unit transfers, it would be transparent for income and exempt from tax on gains (with investors being taxable when they dispose of their units or they are redeemed). Ideally also, seeding relief should be available.	A new UK vehicle, in the flexible and tax efficient form proposed for the PIF, will be widely welcomed in the industry, for many of whom using an offshore vehicle is sometimes still the only real option for their business plan. It will take the form of a UK contractual fund, but (using entirely non-technical language) may be more easily thought of by some as an onshore JPUT (without all the complexity of the new NRCGT rules at fund level and the administration burden of being offshore). As such, it could be a very useful additional to the range of local products. Though unregulated by the FCA, it will still be an alternative investment fund for AIFMD and will require a full scope AIFM and depositary.
Non-resident gains – introduction of 10% holdings threshold for non-resident insurance companies and funds	Since April 2019, where non-residents hold an interest in a UK property rich collective investment vehicle (CIV), they will potentially be subject to UK tax on gains on any disposal of that interest, regardless of the size of their holding (ie the usual 25% threshold is disapplied). Helpfully, the government proposes to change this, with retrospective effect to 2019, and has published draft regulations, for consultation, for a new 10% threshold before the charge bites for disposals of interests in CIVs for, broadly, (i) a non-resident life insurance company that does not have a UK permanent establishment, and (ii) a widely held offshore CIV for whom holdings of UK land and UK property rich companies are not expected to be more than 40% of the market value of its investments.	We expect the government to introduce the proposed changes in a form substantively similar to the draft to date. This will be a welcome development for UK real estate funds with actual or potential non-resident investors that are either overseas insurance companies or collective investment vehicles. To date, the lack of such a threshold has made it unattractive for those investors to take minority stakes in UK real estate funds, not only because of the UK tax liabilities that may arise on any disposal, but also due to the consequential administrative burden that would otherwise result.

Wider tax issues

Tax change	Introduction	What does this mean for the real estate sector?
Introduction of revenue raising measures in response to Covid-19	It is widely anticipated that the government's response to Covid-19 will, necessarily include tax increases and there has been much speculation about what measures may be introduced. One potentially at the top of expected list is a change in the tax treatment of the self-employed, as the Chancellor alluded to this in his announcement of the Self-Employment Income Support Scheme. This would likely be in the form of NIC rates more equal to those of employees. Other areas of speculation have included aligning CGT and income tax rates, changing the CGT rules in line with the Office of Tax Simplification's report (see below), increasing corporation tax and introducing a new net wealth tax.	It would not be surprising if the Budget, scheduled for 3 March 2021, contained some major tax announcements. While at present, it is hard to second-guess with any accuracy what these will be, businesses in the real estate sector should be alive to any announcements.
CGT review	In November, the Office of Tax Simplification published a report on capital gains tax (CGT). The report contained a series of recommendations that could, if implemented, have a significant impact on the scope of UK taxation of chargeable gains. This did not specifically recommend that CGT rates be aligned with income tax rates. However, it did, amongst other things, recommend that if the government considers reductions to distortions to behaviour to be the simplification priority, it should consider either more closely aligning those rates or addressing boundary issues between the two taxes. Whether the review is a precursor to the introduction of revenue raising measures to fund the government's Covid-19-related expenditure is currently unclear.	Those in the real estate sector should monitor this issue, which has obvious potential implications, including for those with carried interest and in relation to estate planning. However, it remains to be seen how the government will respond to the report, which, after all, contains recommendations only. Further clarity seems unlikely before the forthcoming Budget in March.
DAC 6	The government has removed DAC 6 Hallmarks A, B, C and E from the scope of the UK's implementation of EU directive 2018/822 (DAC 6), with effect from the end of 31 December 2020. Reporting under DAC 6 will still be required by UK intermediaries and taxpayers for a limited time, but only arrangements which trigger the D Hallmarks (arrangements which obscure beneficial ownership or which thwart effective OECD CRS reporting) will be reportable. HMRC has confirmed that this change also applies to arrangements entered into prior to 1 January 2021. Over the coming year, the government intends to repeal the legislation implementing DAC 6 in its entirety and implement the OECD's mandatory disclosure rules instead.	This reduction in compliance is welcome news, despite the short notice (given that the first UK reporting dates are imminent) and much wasted effort to date. However, while this change will reduce the DAC 6 compliance burden on businesses that focus mainly on the UK, those with wider EU operations will still need to operate the full rules in the relevant jurisdiction.
Company residence and permanent establishment in light of Covid-19 travel restrictions	Travel restrictions caused by the Covid-19 pandemic have led to difficulties for directors physically attending board meetings in the company's jurisdiction (particularly for those not tax resident in the same jurisdiction as their company). If such directors attend remotely or, in the absence of board meetings, make important decisions where they are located, there is a risk that the company could be considered resident where the relevant directors are located.	Changing corporate tax residence or creating a permanent establishment can have a significant tax impact. Those in the real estate sector should monitor the situation carefully and consider taking appropriate steps, for example, appointing new directors resident in company's intended jurisdiction of residence and providing directors and employees with clear policies of what actions they can take and decisions they can make from their home jurisdictions without generating corporate residence or permanent establishment concerns.
OECD Pillar One and Two	Building on its original BEPS project, the OECD is working on two proposals that could have huge consequences for international taxation. "Pillar One" seeks to introduce a new taxing right for countries in relation to non-resident companies that do not have a permanent establishment there and is aimed at "consumer" facing businesses and those providing automated digital services. "Pillar Two" seeks to introduce a global minimum tax rate. Both pillars have an ambitious timeline of reaching consensus by mid-2021.	Those in the real estate sector should monitor the progress of these projects. Even if consensus is reached by mid-2021, the timetable for implementation is unclear and we would expect it to take at least two to three further years for reforms as fundamental as those being considered to be implemented internationally.
Call for evidence on VAT grouping	HM Treasury issued a call for evidence relating to VAT grouping that closed in November. The review included views on potential changes to the current rules which would, if adopted, significantly recast the UK's VAT grouping framework. The three areas covered are the VAT establishment provisions, compulsory VAT grouping and grouping eligibility for certain entities, including limited partnerships.	It is not clear currently which (if any) of the wide-ranging proposals discussed in the call for evidence might be adopted. Those in the real estate industry will want to track the development of this issue, especially, if they are in sectors, such a residential, where irrecoverable input VAT is potentially a real cost. Of particular interest to real estate fund managers will be the review of VAT grouping rules for limited partnerships (both English and Scottish) and the impact of any consequential changes to the VAT treatment of management fees.