TRAVERS SMITH

# Real Estate Tax Checklist

## What should be on your radar?

March 2022

# Introduction

**It is certainly a busy time for those in the real estate sector with an interest in tax matters. Next month (April) sees the introduction of the residential property developer tax (RPDT), changes to the REIT rules and the introduction of the qualifying asset holding company (QAHC) regime. In addition, the government's ongoing review of the UK funds regime looks set to generate further reforms relevant to real estate, as do various international initiatives (such as the EU's shell entity proposals). There are also potential changes to various aspects of asset-level (or "bricks and mortar") taxes coming down the line.**

With so many tax changes imminent or on the horizon, it can be difficult for those in the real estate sector to stay on top of things. So this briefing provides a checklist of key tax issues you should be aware of (including potentially significant future developments) and sets out the actions that you might consider taking in preparation for the changes.

## 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 in this briefing.

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# Real Estate Vehicle Tax

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| **Introduction of QAHC regime from 1 April 2022** | A new tax privileged regime for QAHCs will come into force from April.<br><br>A QAHC must satisfy several eligibility criteria, including that (broadly) it is an investment company 70% owned by "good investors" (including, diversely owned funds, pension funds, UK REITs (and certain similar overseas companies) and sovereign wealth funds).<br><br>The generous tax benefits available to QAHCs do not apply to all their activities. In particular, UK real estate income and gains are subject to corporation tax in the normal way. However, QAHCs are exempt from gains on non-UK real estate and shares (provided the investee company is not UK property rich) and, provided it is subject to local taxation, non-UK real estate income.<br><br>In addition, a QAHC is exempt from tax on profits from loans and derivative contracts relating to its overseas property business, does not have to withhold tax from interest it pays and can more easily make share repurchases that are treated as capital (rather than income) transactions for UK shareholders (with share repurchases also benefitting from an exemption from stamp duty).<br><br>For more information, please see our full briefing on the new regime and our recent webinar. | The introduction of the QAHC should significantly enhance the UK's attractiveness as a jurisdiction through which to hold overseas property, with the simplicity and breadth of the corporation tax exemption on the profits of an overseas business being especially welcome.<br><br>It will be interesting to see whether managers of pan-European real estate funds start adopting UK-based holding structures built around QAHCs for future funds, in preference to Luxembourg and other common foreign holding company jurisdictions. If the QAHC regime makes the UK more competitive vis-à-vis those jurisdictions from a tax perspective, it may be that other factors (not least the fact that many investment professionals are based in London) will tip the balance in favour of the UK.<br><br>However, while the QAHC offers competitive tax advantages as a vehicle for the holding of non-UK real estate, it does not contain any special benefits for the holding of UK real estate, meaning that profits of UK property business would be subject to corporation tax in the usual way (following the principle of local taxation of real estate income and gains). |
| **Government announces next steps in review of UK funds regime (the Review)** | The Review, which started in March 2020, has consisted of a number of different elements, and has led to next month's introduction of the QAHC regime and amendments to the REIT rules. Another part of the Review was the publication in January 2021 of a wide-ranging call for input (**CFI**) in relation to which the government has recently published a summary of responses (the **Response**). For more details please see our briefing on the Response.<br><br>The Response sets out the government's next steps on a variety of issues, several of which are relevant to the real estate sector. This includes consideration of further changes to the REIT regime and the potential introduction of a new form of unauthorised fund in the form of a contractual scheme aimed at professional investors (both discussed below). | The Response shows that the government is planning further significant and welcome reforms to the UK funds landscape.<br><br>The government appears to be in listening mode and, if the development of the QAHC regime is any guide, is likely to be prepared to take on board industry comments. Therefore, those in the real estate sector who are interested in any of the proposals should consider providing feedback to the government both on matters of policy and practicalities. |

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| **Changes to the REIT regime from April 2022** | Changes to the REIT regime to make it more attractive are coming into force in April.<br><br>These changes include: (i) allowing REITs to be unlisted where one or more "institutional investors" hold at least 70% of the REIT's ordinary share capital, and (ii) disapplying the "holders of excessive rights charge" in respect of property income distributions (PIDs) paid to investors who are entitled, under relevant UK domestic REIT withholding tax rules, to gross payment (but not those entitled to be paid gross by virtue of provisions outside the REIT code, such as by making a treaty relief claim).<br><br>For more detail on the changes, please see our briefing. | The reforms should make the REIT structure more accessible for fund managers, especially in relation to institutional investors who can access the unlisted variety.<br><br>Asset managers who have previously discounted the REIT from their range of real estate fund vehicles may wish to factor it into their thinking going forward. |
| **Further changes to the REIT regime** | The Response has confirmed that the government is considering further changes to the REIT regime.<br><br>The possible changes include: (i) removing the requirement that a REIT be subject to both (rather than just one of) the general corporate interest restriction and the REIT regime interest cover test, (ii) amending the 3-year development rule, (iii) allowing a REIT to hold a single property, and (iv) removing withholding tax on PIDs paid out of foreign property profits taxed abroad. The interaction between the REIT and QAHC regimes will also be considered. | The government seems determined to introduce further reforms to make the REIT regime more attractive, a move that will be welcomed by the real estate sector.<br><br>Although we do not yet know what reforms will be taken forward, it seems that things could move quite quickly, with the Response saying that the government will explore whether some of the changes (including the interaction between the REIT and QAHC regimes) can be delivered in the next Finance Bill. |
| **Potential introduction of unauthorised onshore contractual fund** | The Response confirms that the government will work further to explore options for a new form of unauthorised fund in the form of a contractual scheme aimed at professional investors, envisaging that this will be an attractive vehicle for the real estate sector.<br><br>It is expected that the tax rules applying to the unauthorised contractual fund would largely replicate those for the co-ownership authorised contractual fund (**CoACS**), including income transparency, no stamp taxes on unit transfers and the fund not being subject to tax on gains (with investors being subject to tax on gains when they dispose of their units, not when the fund disposes of its assets). | A new form of UK unauthorised fund is a potentially exciting development, although much will turn on the extent of the tax privileges from which it benefits. If they mirror those that apply to the CoACS, then the new vehicle may present a viable alternative for commonly used offshore structures (in particular, the JPUT).<br><br>The Response is unclear on the VAT position for fund management supplies to the new fund and may indicate that it will not benefit from the VAT exemption for such supplies that applies to CoACS. Those in the sector will wish to keep an eye on this point, as it may result in real VAT costs for funds that do not make entirely VATable supplies. |

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| **Implementation of OECD Pillar Two (global minimum corporate tax rate) from 2023** | As mentioned in previous briefings, the main plank of Pillar Two is the Global anti-Base Erosion rules (**GloBE rules**) that seek to establish a global minimum corporate tax rate of 15% for multinational enterprises (**MNEs**) that meet a €750m turnover threshold. There will be various exclusions, including for investment funds that are ultimate parent entities of an MNE group and pension funds (and any holding vehicles used by such funds).<br><br>The GloBE rules will impose top-up taxes where the effective rate of tax of an MNE in a jurisdiction is below the global minimum corporate tax rate (15%) and will also allow source taxation (for example, withholding taxes) on certain cross-border related party payments that are subject to tax below a minimum rate of 9%. | The timetable for implementation of Pillar Two is tight, with the OECD (ambitiously) asking jurisdictions to legislate the Pillar Two rules in 2022, with most of them taking effect from 2023. The GloBE Model Rules were published in December 2021 and a commentary on them followed in March this year. The rules have been heavily criticised by business leaders for their complexity. However, given the substantial levels of political backing for the changes, it may be that such concerns will not be allowed to materially delay the implementation timetable.<br><br>As GloBE focuses on an MNE's "effective tax rate" in a jurisdiction (and not that jurisdiction's headline rate), many real estate businesses may need to carefully consider whether they may be affected by these rules.<br><br>The GloBE Model Rules contain exemptions for investment funds which include an exclusion for "Real Estate Investment Vehicles". However, the scope of these exemptions is not entirely clear, particularly in relation to REITs, and so it will important to see how these are dealt with by countries in their domestic implementing legislation. |
| **EU directive on shell entities (ATAD 3)** | The EU Commission has published a draft directive designed to tackle misuse of entities resident in EU member states that do not have sufficient substance. Entities within the scope of the directive are subject to adverse tax consequences. There are also increased information reporting requirements which extend to entities at risk of being within scope as well as those that actually are.<br><br>For more detail please see our recent briefing on the shell entities directive which includes a flowchart to help businesses navigate the new rules and assess whether the directive is likely to apply to them. | On the current drafting of the proposals it seems that property holding companies will potentially be within the scope of the new regime.<br><br>This is likely to mean that real estate investment businesses will need to take steps to bolster the substance of their EU holding companies to prevent additional reporting or adverse tax consequences, although the directive is only in draft and there is a lot of uncertainty at this stage as regards how EU member states will implement the directive (should it be implemented). |

# Bricks and mortar tax

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| **Introduction of residential property developer property tax (RPDT) from 1 April 2022** | RPDT is part of a package of measures to help pay for the remediation works as a result of the cladding crisis following the Grenfell Tower tragedy. The intention is for RPDT to raise at least £2bn over a decade and for tax to be repealed once its objectives are achieved.<br><br>Broadly, RPDT will apply (in addition to corporation tax), at a rate of 4%, to corporation taxpayers in respect of their profits, exceeding a £25m annual group allowance, from residential property development activities relating to UK land in which they (or a related company) have (or, in certain circumstances (such as forward-funding arrangements), have had) a relevant interest. Importantly, it only applies to land held as trading stock by the developer (or a related company) so investors, including build-to-rent (**BTR**) investors, should not be within scope and the RPDT should not be payable by any third-party contractors working on a residential property development. Profits are calculated in the same way as for corporation trading profits but with important differences, for example, there are no deductions for finance costs. In addition, the regime contains various special rules for joint ventures. | Developers should factor RPDT into the financial modelling of their developments and put systems in place to enable them to comply with their RPDT obligations.<br><br>Developers should note that the tax potentially applies to profits arising before 1 April 2022. This is because of the way RPDT applies to accounting periods that straddle 1 April 2022. Under the rules, the straddle period is divided into two accounting periods, with the first ending on 31 March 2022 and the second commencing on 1 April 2022. Profits allocated to the later period are within RPDT's scope. However, such allocation is on a time basis so that if, say, the company's actual straddle period began on 1 October 2021, such that it was deemed to have two six month accounting periods for RPDT purposes (01/10/21 – 31/03/22 and 01/04/22 – 30/09/22) half of its profits would be allocated to the latter period, even if the developments that generated them were completed before 1 April 2022. |
| **Changes to business rates rules** | In the Autumn 2021 Budget the Chancellor announced various changes to the business rates. These included freezing the business rates multiplier until 2022/23, the introduction of a temporary relief (until 2022/23) for retail, hospitality and leisure businesses and a new business rates improvement relief to help businesses decarbonise and improve their properties. For more detail please see our Budget briefing.<br><br>In addition, the government has also recently consulted on having revaluations every three years and is considering the responses. For more detail of the consultation please see our Tax Administration and Maintenance Day briefing. | The proposed changes should provide temporary relief from rates to many in the residential property sector. However, they are unlikely to address the wider concern from many in the retail sector that the current rates regime unfairly burdens them in comparison to their online competitors. In this regard, it will be interesting to see whether the government introduces a new online sales tax (on which a consultation has recently started) to fund a reduction in business rates.<br><br>Those in the sector will also wish to keep an eye on the outcome of the revaluation consultation (including its proposals to significantly increase the amount of information that should be provided to the Valuation Office Agency). |

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| **Confirmation of HMRC position on VAT on dilapidation payments** | In September 2020 HMRC announced that it was, with retrospective effect, changing its long-standing policy of treating contractual termination fees and compensation payments (potentially including dilapidations) as outside the scope of VAT. This guidance was then effectively put on hold following a strongly adverse industry response, but last month HMRC confirmed that it will be taking a modified version of the position it set out in 2020.<br><br>From a real estate perspective, the revised guidance confirms that HMRC will continue to regard genuine dilapidation payments as outside the scope of VAT (and not further consideration for the supply of a lease). However, HMRC notes that it might depart from that view if in individual cases it finds evidence of value shifting from rent to dilapidation payment to avoid accounting for VAT.<br><br>For more detail please see our briefing. | The confirmation from HMRC regarding dilapidations payments will be welcome news for those affected. HMRC took into account feedback received from the real estate industry, which clearly demonstrates that it is worthwhile making representations to HMRC in relation to proposed changes of law and guidance.<br><br>One area where the position has changed concerns the VAT treatment of fees paid to break a lease. Previously, where the fee was provided for in the lease, it was treated as outside the scope of VAT, whereas a fee separately negotiated was exempt (subject to the recipient's option to tax). Now, all lease break fees will follow the latter position, irrespective of whether or not they are provided for in the lease. |
| **SDLT consultation on mixed property purchases and multiple dwellings relief (MDR)** | In November last year, the government published an SDLT consultation looking at (a) reforming the way in which SDLT applies to 'mixed' property transactions (i.e. transactions involving a mixture of residential and non-residential property), and (b) introducing restrictions on the availability of MDR. The consultation closed last month and HMRC is considering the feedback.<br><br>For more detail please see our Tax Administration and Maintenance Day briefing. | The consultation aims to deal with perceived flaws in the current rules.<br><br>In the case of a mixed property transaction, the concern is that purchasers can pay non-residential SDLT rates (rather than the higher residential rates) if a transaction has any non-residential element, however small. In the case of MDR, the concern is that it is being inappropriately claimed in the case of what is really a single property.<br><br>The proposed reforms would, however, have a wider impact than simply preventing abuse and are likely to add further complexity for those involved in the residential sector when assessing their SDLT liability. |
| **Simplifying the VAT land exemption** | Following a wide-ranging call for evidence last year on simplifying the VAT land exemption, HMRC have indicated that they intend to explore two of the original proposals, namely: (a) establishing a workable definition of "short term" or "minor" interests in land that would be automatically standard-rated, and (b) making all supplies of land standard rated for VAT purposes, subject to a limited number of exemptions. However, it would appear that a number of the other proposals will not be taken forward.<br><br>For more detail please see our Tax Administration and Maintenance Day briefing. | This is certainly something to keep an eye on since any change (and in particular, any move to automatically standard-rate most supplies of land) would have a significant impact on the real estate sector.<br><br>More positive is the suggestion from HMRC that it might be time for a review of the option to tax anti-avoidance rules. This is something that Travers Smith pushed for in its response to the call for evidence. Given the difficulties these provisions can cause in arm's length commercial transactions without any tax avoidance motive or purpose, meaningful reform in this area would be very welcome. |