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Knightsbridge Wealth

technical news

For professionals working with international clients

IN539 – Changes to UK property ownership rules

The attractive tax regime for foreign investors in UK commercial real estate is changing. Foreign investors and their advisers should now consider if traditional structures remain effective, in light of new UK Government proposals being introduced in both April 2019 and 2020.

Tax on Rental Profit

- Overseas investors who are not tax resident and do not carry on a trade in the UK are only liable to pay basic rate income tax (currently 20%) on rental profits during their period of ownership of a UK commercial investment property.

  To achieve this favourable tax treatment, it is important to use an offshore company to acquire the UK property and that the company is managed and controlled in a manner that ensures it remains resident outside of the UK for tax purposes.

- Where an investment is made in the name of a non-resident individual, applicable tax rates are equivalent to the UK income tax rates (up to 45%).

  The UK Government has announced that it will bring non-UK resident companies with UK property income within the scope of corporation tax from April 2020. This will mean that UK rental profit will be subject to UK corporation tax at a rate of 17% (the anticipated corporate tax rate in April 2020).

While the lowering of the tax rate is positive, falling under the UK corporation tax regime will mean that, from 2020, the UK's corporate interest and loss restriction rules will be relevant for those with net interest expenses of more than £2m per year.

Capital Gains

Currently, where a non-UK resident investor acquires a UK commercial property for investment purposes, any capital gain arising on a subsequent disposal of the property will not be subject to UK tax. This changes in April 2019, meaning that from that almost all non-resident owners of UK land will be within the scope of UK tax on gains, including "widely held" investment funds. This brings the UK into line with most other tax jurisdictions and the concept that land should be taxed where it is situated.

The precise rules are not yet known, but there is likely to be a rebasing of the cost of the property as at April 2019, meaning that only gains from that point onward will be charged to tax.

Property Developers and Traders

In 2016, anti-avoidance rules were introduced to counteract any claim that a development or dealing trade relating to UK property was actually being carried on outside the UK, and therefore not subject to UK tax.

Profits from a development project are therefore within the scope of income tax or corporation tax, depending upon who is carrying it out. These rules also apply where there are arrangements to sell the development company, rather than the land itself. They apply where shares (for example) are sold and they derive at least 50% of their value from UK land.

Stamp Duty Land Tax (SDLT)

Acquiring a UK commercial property directly incurs a charge to SDLT (a purchase tax) as follows:

Property Price	SDLT Rate% Charged on part of purchase price within each band
£0 – 150,0000	0
£150,000 – 250,000	2
The remainder	5

No such tax generally arises when acquiring a company that itself holds UK property. As a result, there is benefit in acquiring and disposing of UK commercial property via a company vehicle, particularly where that company is based offshore in a jurisdiction that does not charge transfer tax on share dealings.

Value Added Tax (VAT)

The sale of a freehold or long leasehold title to a commercial property will, by default, be exempt from VAT. However, property owners have the option to 'opt to tax' their property, which may make the sale of that property subject to VAT (but, as a consequence, also entitles the property owner to claim credit for VAT charged to them on their overheads).

This is a complex area and, when acquiring UK commercial property, due diligence will be required to establish whether the property is subject to VAT or not, and what impact this may have for the purchaser.

On Death – Inheritance Tax (IHT)
From 6 April 2017, all UK residential property, whether held directly or indirectly, became liable to UK IHT (with the exception of property owned by diversely held vehicles). UK commercial property held directly by an individual is similarly liable to a UK IHT charge; however, commercial property held via an offshore company is not.

There is, at this time, no indication that commercial property held indirectly through a company or similar vehicle will give rise to an exposure to UK IHT; however, in light of recent changes this might be a logical next step.

New protection for households

The government plans to set up a new regulator that will oversee the activities of letting agents and managing agents of leasehold properties, in an effort to protect the almost nine million households in England's privately rented and leasehold sectors.

Under the proposals from the Ministry of Housing, Communities and Local Government, a new mandatory code of practice will impose a minimum standard of behaviour on letting and managing agents, with sanctions imposed on those who fail to adhere to the code. At the moment anyone can set up a business as a property agent, regardless of their qualifications or experience – although since October 2014 letting and property management agencies have been required to be members of an approved redress scheme, which can provide an independent assessment of complaints against the agency.

Although the new regulator has been tasked with overseeing both letting agents and managing agents, the problems in each sector are obviously different. On the lettings side, both tenants and landlords often complain that agents charge extortionate fees for simple administrative tasks such as credit checks, obtaining references, and arranging for tenancy agreements to be signed. Moreover, during the tenancy some letting agents omit to arrange repairs where necessary, or fail to pass on tenants' rent to landlords.

Meanwhile, in the leasehold sector, leaseholders often find themselves on the receiving end of eye-watering bills for repairs and maintenance, with managing agents awarding contracts for work with little regard for cost control. The new code of practice will include a system to help leaseholders challenge unfair fees, including service charges, and support for leaseholders to switch managing agents where they perform poorly or break the terms of their contract. The regulator will also look in greater depth at unfair additional charges levied on leaseholders and on homeowners who own the freehold to their house. These include restrictive covenants, leasehold restrictions and administration charges.

Under the government's proposals, both letting and managing agents will be required to undertake continuing professional development and training and obtain a nationally recognised qualification to practice. Additionally, at least one person in every organisation will be required to have a higher qualification.

The new regulator will be given strong powers of enforcement for those who break the rules. Letting and managing agents who fail to comply with the code will not be permitted to trade, while the worst offenders could face criminal sanctions. A working group comprising letting, managing and estate agents, as well as tenants and regulation experts, will be established to draw up more detailed proposals that are expected to be finalised sometime in 2019.

In the meantime, the government's pledged ban on tenant fees and cap on deposit amounts, as well as legislation requiring letting agents to be part of an approved client money protection scheme, which protects tenants and landlords in the event that the agent goes bust or acts fraudulently, are also set to come into effect in spring next year.

Navigating interest-rate rises

Loose monetary policy has driven investors to take unnecessary risks, and the tightening process may be ugly. One big mystery that remains about our recent era of ultra-low interest rates and money printing (quantitative easing – QE) is the question of the exact impact it has had on investor behaviour. Financial commentators often talk about the 'reach for yield' – whereby low interest rates encourage investors to take more risks simply to generate some income, rather than because they believe those risks are actively worth taking.

Why does this matter? If markets are efficient and investors dispassionately bet on future outcomes while incorporating all available data into their decisions, then they shouldn't 'reach for yield' at all – they shouldn't be pumping money into riskier assets just because they feel aggrieved by the incredibly low nominal rates available on safe assets, because that's irrational.

Of course, as we all know, investors aren't narrowly rational and markets aren't perfectly efficient.

Several academic studies suggest that once interest rates fall below a certain level (it varies depending on the study), investors are indeed willing to pile into an asset that didn't previously appeal to them, even if the risk-reward trade-off hasn't changed.

This shouldn't be a huge surprise. Indeed, it's the main mechanism by which QE works. The whole point is to push investors into riskier assets by forcing down real interest rates. In effect, the cure for the post-bubble bust was to inflate another bubble. In 2009, just as central banks – led by the Federal Reserve under Ben Bernanke – were flooding the world with liquidity, behavioural investment expert James Montier wrote about a 2002 experiment by Nobel prizewinner Vernon Smith.

Smith and his team found that investors who had been caught out by bubbles and busts previously would trade more cautiously in future – except, that is, when monetary conditions were so extraordinarily loose they felt they had little choice but to trade more aggressively. "If the environment is one of high liquidity...a bubble can be sustained...despite experience," as Smith put it. If investors have been reaching for yield, the logical conclusion is that, once rates reach a certain level, share prices will take a hit. For example, a 3.5% yield on the US Treasury bond could be enough to tempt investors out of stocks and back into 'less risky' assets. This is another reason to expect central banks to raise slowly. But navigating a world where rates are rising will certainly be a lot trickier than investing in one where rates are coasting smoothly downhill.

US-China trade tensions worsen

A new round of US trade tariffs on $16bn-worth of Chinese imports kicked in last month on goods including semi-conductors, chemicals and electric scooters. Beijing retaliated with levies on the same amount of American goods, including fuel and medical equipment. This is the second round of tit-for-tat measures and $50bn of imports on each side now face levies.

Trump insists he plans to impose taxes on over $500bn of Chinese goods unless Beijing agrees to major changes in its intellectual-property practices and industrial-subsidy programmes. China has denied Washington's allegations that it systematically forces the unfair transfer of US technology and insists it adheres to World Trade Organisation rules.

Beijing has plenty of fiscal and monetary tools to keep the economy afloat. The country's property sector and consumer spending are holding up well. China is well placed to outlast the US in an economic war of attrition.

The US Federal Reserve has flagged a trade war as a risk to the US economy but one that's still over the horizon. For now, Jerome Powell, chairman of the Fed, expects stronger growth. What's more, Mexico and the US have agreed to refine the North American Free Trade Agreement. Whilst we're never more than a tweet away from disaster on trade, there is – for now – optimism.

US housing wobbles

The US housing market triggered the global financial crisis in 2008 when mortgage-backed securities plummeted, leading to a chain reaction across the banking system. So, investors tend to keep a very close eye on it. And the latest news suggests that the recovery from the crisis, which has seen prices hit new all-time highs, may be beginning to falter.

Housing starts in June plunged 12.3% from May, according to the US Census Bureau figures recently issued. It was the largest monthly percentage decrease in a year and a half. Analysts had pencilled in a 2.2% drop.

Housing starts are an economic indicator reflecting the number of privately owned housing units on which construction has begun. Analysts believe the current slide might be due to a shortage of qualified construction workers, along with the rising costs of imported materials such as lumber (partly a result of tariffs).

The decline in house construction was reported across many regions, with residential building permits, which can signal how much construction is in the pipeline, falling 2.2% last month. The constraints encountered by developers coincide with a squeeze on demand. While prospective buyers are benefiting from high rates of employment and wage growth, they are also grappling with rising long-term interest rates and the consequent higher mortgage costs.

A lack of affordability is also denting demand with price rises easily outpacing wage gains. The Case-Shiller National Home Price index, which measures average house prices in major metropolitan areas across the US, recently rose by 6.4% year-on-year, down from 6.5% the previous month. But while price gains may have lost a tiny bit of momentum, prices continue to grow faster than both incomes and inflation. Half of the US housing markets in the country are now above their 2006 peaks, according to The Wall Street Journal.

6.4%

Recent house price rise within Metropolitan areas across the US

The big picture is still positive. Housing starts rose by 7.8% year-on-year in the first six months of 2018. The best of the post-crisis rebound may be over, however, and a surge in prices looks unlikely now. But given what happened the last time this market went berserk, that's probably just as well.

Minding the Lifetime Allowance Cap

Although the government insists it's a tax that hits only a handful of very wealthy savers, the lifetime allowance (LTA) on pension funds affects more people than you might think. HM Revenue & Customs is raising steadily more cash from the system: in the 2016-2017 tax year, pension savers hit by the LTA handed over £110m, three times more than in 2015-2016. The cap affects all UK residents, regardless of their domicile, and international clients need to be aware that pensions will not be the most affective investment strategy in many instances.

The LTA caps the amount you may build up, in total, across all the private pension schemes you have, whether with an employer or individually. In the current tax year, the limit is £1,030,000 – any savings above that level are subject to a 55% tax when you start cashing in your pensions.

Special rules apply to savings in defined-benefit pension schemes that guarantee a pension pay-out related to salary. For the purposes of the cap, multiply the pension you have been promised by 20 – so if you've built up an entitlement to a £25,000 annual pension, say, your savings would be worth £500,000.

So why are more people falling foul of the allowance? One reason is that it has been repeatedly reduced in previous years, from a high of £1.8m in 2012. Last year, the government promised to increase the allowance in line with inflation, but this will see only modest rises for the foreseeable future. Investment returns in recent years have been healthy, buoying the value of many savers' pension funds, and tax relief on pension contributions, even for high earners, is still generous.

The power of compound interest means many people who wouldn't expect to run into problems with the LTA may be in for a nasty surprise. A 35-year-old saver with £300,000 of pension savings or a 45-year-old with £400,000 could easily come up against the cap as they approach retirement, assuming they continue contributing at current levels and investment returns are reasonable.

The best way to avoid this tax trap is to take action early. Monitor your exposure to the cap over time. If you're getting close to the limit, consider reducing or even stopping contributions. Early retirement could be another option. Other tax-efficient savings schemes, including individual savings accounts, offer a different way to put money by while still benefiting from tax breaks. But even if you have to switch savings into taxable investment plans, you'll still be better off than paying a 55% penalty charge on excess pension cash.

Contact us

If you require further information about our services and how we can assist your clients, then please call us or send us an email about how and when we can contact you.

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