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# How Non-Resident Property Developers Can Mitigate Tax On UK Projects

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*While the financial crisis has made life challenging for many real estate investors, the prime London property market continues to defy expectation. In a world of uncertainty it seems there is a flood of overseas investors falling over themselves to exchange their dirhams, roubles, dinars, renminbis and even euros for the peace of mind that comes with an investment in a super-prime SW1 or W1 postcode in London.*

*This article highlights the UK tax considerations for overseas investors and provides two examples of acquisition structures currently being adopted by those investors for UK real estate investments.*

The UK tax system draws a distinction between the following types of profit arising from UK property investment:

-- UK rental income that is generally taxable (subject to allowable deductions for financing and other expenses) whether the recipient is a UK resident or non-resident.

-- Capital gains realised on the sale of UK investment property that are generally not taxable for non UK residents. This is an unusual feature of the UK tax system since most other jurisdictions seek to tax non-residents on gains realised on the sale of real estate located "in-state".

-- Trading profits arising on UK property development activities that are generally taxable in the UK.

An overseas investor will also be concerned with UK inheritance tax that is potentially chargeable on UK real estate held directly by the overseas investor. In addition, there is of course stamp duty land tax payable by the purchaser of UK real estate (at a rate of 5 per cent for deals over £1 million).

Despite this general scope of taxation, possibilities exist, through appropriate structuring, to minimise the UK tax burden for overseas investors investing in UK real estate (see examples 1 and 2 below):

*Example 1*

**Big Ticket (£20 million+) property development**

This explains a simplified structure that could be adopted by overseas investors in a big ticket UK property development. In this example, we are assuming that the investors are not UK tax resident:

Equity funding can be contributed by the investors to an investment company ("Investco") owned by them and resident in an offshore jurisdiction that has a beneficial tax treaty with the UK for property development activities (such as Jersey).

Debt funding can also be advanced by the investors to an independent finance company ("Finco") typically resident in a jurisdiction that has a beneficial tax treaty with the UK (such as Luxembourg). Finco will then on-lend to Investco by way of mezzanine finance (i.e. debt which has a lower priority (but higher coupon) to any bank debt).

Investco acquires the UK development site. Bank financing (secured on the UK development site) may also be utilised by Investco. Investco will then enter into a development contract with an unrelated UK resident developer.

Such a structure, correctly implemented, should typically ensure that the investor's return is sheltered from UK tax. Some of the technical considerations are explained below:

-- To ensure the non-resident investor does not have a taxable presence in the UK (i.e. a "PE") the non-resident investor should not have an office or other fixed place of business in the UK. Perhaps helpfully, the Jersey/UK tax treaty does not contain a "construction PE" article so, arguably, a Jersey resident investor in UK property could never have a UK taxable presence.

-- HM Revenue & Customs' typical angle of attack might be to argue that the Jersey company is actually a resident (i.e. has a taxable presence) in the UK. This could be the case if the decisions of the Jersey company are in fact taken by the investors when they are sitting in their SW1/W1 mansions (see Example 2 below). We typically advise investors on the necessary operating guidelines to protect structures from such a residency challenge.

-- The separation of the equity and debt financing might seem like over-engineering but will be of great importance if HM Revenue & Customs were to successfully argue that Investco has a UK taxable presence. In that case, Investco would be taxed in the UK on its profits, but would generally be allowed a tax deduction for the interest incurred on the bank and mezzanine financing.

-- There may also be a concern that interest payable to Finco on the mezzanine financing would be subject to UK withholding tax (at a rate of 20 per cent). The Luxembourg/UK tax treaty allows a full exemption from UK withholding tax for interest paid to a Luxembourg resident company that is the "beneficial owner" of the interest. However, "conduit" entities that have a pure "back-to-back" obligation are vulnerable to an argument that they are not the "beneficial owner". This risk can generally be mitigated through giving each party separate rights and obligations.

The result is a highly tax efficient UK property development structure for offshore investors.

*Example 2*

**Super-prime (£5 million+) residential investment**

In this example, we are assuming that the overseas investors are not domiciled in the UK but may at some stage become resident in the UK.

The real estate will be acquired by an offshore company (e.g. Jersey) whose shares will likely be held by an offshore discretionary trust. Ideally, the structure should be implemented prior to the overseas investor becoming UK resident (otherwise certain complex anti-avoidance provisions may apply).

Such a structure, correctly implemented, should typically ensure that:

-- the investor's return is sheltered from UK capital gains tax (even if the overseas investor becomes UK resident); and

-- the UK property falls outside the investor's estate for UK inheritance tax purposes.

The structure also allows for the possibility that the shares in the offshore company can be sold, which may assist in marketing the underlying property to a subsequent non-resident purchaser (since a sale of shares in the offshore company will not give rise to UK stamp duty land tax for the purchaser).

**A final word of warning**

Both of the above examples assume that the reader is familiar with the concepts of residence, domicile (and the related concepts of deemed residence and domicile). Readers should be aware that the UK rules on residence and domicile are currently under review and have, in recent years, become increasingly politicised (and consequently less stable).

While significant tax enhancements are available, readers should also appreciate that the UK has very far-reaching anti-avoidance provisions and there is no substitute for advice on the specific facts relating to any particular deal.

**About the author:**

Miles Dean is a founder of Milestone International Tax Consultants, having started his career in international tax in 1994. He is the co-author of *International Tax Systems and Planning Techniques*(Sweet & Maxwell) and *The Principles of International Tax Planning* (Corpus), as well as numerous academic articles. Miles has a varied client base ranging from owner-managed businesses to international investment funds and real estate businesses. Miles has recently advised on a number of high-profile cross-border infrastructure and real estate transactions.