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Moving the Tax Goalposts for UK Land

Changes introduced by the government, having effect in relation to disposals on or after 5 July, could have a major impact on the way transactions involving UK land are taxed.

Background

The government announced, alongside the Budget in March 2016, its intention to ensure profits arising from trading in UK land were brought within the charge to UK tax. The primary aim of the changes was stated to be to ensure equal tax treatment for UK and non-UK resident property developers.

The UK operates a territorial tax system. Taking corporate entities as an example, this means that, before the introduction of the new rules, a company would only be taxed on UK property development (trading) activities if, broadly, it was either:

- Resident in the UK
- Carrying on its trade through a UK permanent establishment (PE), or
- Carrying on its trade through an "avoided UK PE" (under the provisions of the diverted profits tax (DPT)).

By using various structures, most commonly involving appointing a UK-based contractor to carry out the development works, a company was able to avoid triggering a UK tax charge by ensuring:

- It was incorporated, managed and controlled outside of the UK, and
- Did not create a PE in the UK.

New Rules

The new legislation, introduced with effect from 5 July 2016, is lengthy and complex but contains several key elements that could have significant and very broad, implications. These key elements include:

- The territorial restriction on the UK's rules for the taxation of dealing in and developing UK land has been removed, meaning profits from such activities can now be taxed whether or not they are carried on through a UK PE.
- A new, and potentially much wider, definition of what amounts to a taxable "trade of dealing in or developing UK land" has been introduced.
- The new tests apply to all types of taxpayers including:
  - Companies
  - Individuals
  - Partnerships
  - Trustees
- Although the original intention behind the new rules was to target developers using offshore structures, the rules will apply whether or not the taxpayer is tax resident in the UK.
- HM Revenue and Customs (HMRC) will no longer need to rely on invoking the DPT in circumstances covered by these broad rules.

It is particularly important to note that under the new rules a taxpayer can now be treated as carrying on a trade in UK land – i.e. it can now be *deemed* to be carrying on a trade in UK land – if it either:

- Acquires land where its main purpose (or, crucially, *one of* its main purposes) is to realise a profit or gain on sale, or
- Develops land where its main purpose (or, again, one of its main purposes) is to realise a profit or gain on sale after the development is completed.

To illustrate the potential breadth of the new rules, situations where a company decides to dispose of surplus land previously used for its genuine investment business, which it has decided to redevelop before selling on, could be caught.

The threshold for a purpose being a "main purpose" is, especially in the light of recent case law, lower than one might expect and will (of course) depend on the specific facts and circumstances.

By way of example, however, *any* person acquiring an investment property will, naturally, be looking to achieve capital growth over time as well as receiving a rental income during their period of ownership. Under the new rules, the crucial question then becomes, at what point during the ownership of that investment property does the potential future sale become one of the "main purposes" for holding it? In other words, at what point does an asset, held for genuine investment activities, form part of a company's trading stock?

The new rules will also apply to indirect transactions in land in order to catch any profits and gains deemed to derive from UK land. These anti-enveloping provisions will, for example, catch the sale of an interest in a company, partnership or fund that holds the underlying UK property. In effect, the tax liability flows through any legal holding structure to the ultimate holder of the economic interest in the land and the sale of the interest in the intermediate holding entity will be treated as a property trading transaction.

Finally, in order to combat a perceived risk of avoidance, the package of measures also includes both:

- Specific anti-fragmentation rules that prevent shifting the profits through certain pricing arrangements that could otherwise circumvent the charge, and
- A targeted anti-avoidance rule (TAAR) that ensures any arrangements put in place between Budget 2016 and 5 July 2016 designed to avoid the charge will be ineffective.

Implications

As can be appreciated, the new rules can turn what would have been a capital gain into trading income. This impact alone could have significant consequences.

For individual taxpayers, the top income tax rate is currently 45% whereas the top capital gains tax rate is 28% for residential property, and just 20% for other property. Individuals with a buy-to-let portfolio of UK properties should, therefore, consider whether they could be caught by the new rules.

For pension fund trustees and charities that pay no tax on capital gains but are taxable on trading profits, the position is uncertain. On the face of the new legislation, such entities could, technically, be caught. While it might be assumed HMRC do not intend to tax pension funds and charities on their investment transactions, such entities should consider revisiting their property portfolios in the light of these new provisions in order to identify their purpose in holding the property. As emphasised above, however, the key question will be where the line between investment and trading activity should now be drawn?

The uncertain impact will be broadly similar for real estate investment trusts (REITs) and other investment funds holding an interest in UK property that, while subject to UK corporation tax generally, pay no corporation tax on capital gains but are generally taxed on trading profits. This will obviously have an impact on the tax efficiency of such funds and will inevitably have a knock-on effect on the tax position of their investors.

Conclusion

Although having effect in relation to disposals occurring on or after 5 July 2016, regardless of when the land was acquired, the new rules will form part of the future Finance Act 2016.

As a result of the EU Referendum, and the consequential delay to the progress of Bills through Parliament, the new provisions have been introduced at an earlier than originally expected stage during the passage of the Finance Bill 2016 (i.e. in Public Bill Committee). Report stage and Royal Assent is, therefore, currently now expected to occur in the early autumn, shortly before Parliament rises for the political party conferences.

This delay to Royal Assent may allow for some informal consultation with HMRC over the summer, and possibly for some amendments to be included in the final form of the provisions. It is considered, however, that this is probably unlikely and the rules will not be substantially amended before Royal Assent is obtained.

In addition, HMRC have not yet issued any guidance (draft or otherwise) on how they will interpret and apply the new rules. As a result, taxpayers potentially impacted should assess how the new rules, on the basis of the legislation as published, might affect any of their current or planned transactions now.

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