THE MEANDERINGS OF THE TAXATION OF U.K. REAL ESTATE: WHERE ARE WE GOING?

Author
Naomi Lawton

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INTRODUCTION

A striking feature of the U.K. tax landscape has been the recent introduction of significant changes to the taxation of real estate. Residential property in particular (as opposed to non-residential or "mixed" property – see further below) has borne the brunt of the attack.

Where governments make choices about who, what, and how much to tax, tax policy becomes an emotive issue, never more so than now. It is the area of a government's political strategy that has the most direct and immediate effect on a citizen's pockets. These decisions tend to have a rather focusing effect – an effect that is compounded in this case because the tax in question is on an Englishman's home (or a Welshman's, etc. – you get my drift), which is his castle, as the adage goes. It also affects the desirability of local real estate to foreign investors, whether considering it for personal use or as investment real property.

THE FISCAL SIGNIFICANCE OF PROPERTY

The U.K. housing market is one of the key barometers of the country's economic health. Over the long term, capital growth in real estate can be counted upon to outstrip many other forms of investment. Land is one of the few commodities that is genuinely finite in nature. We cannot produce more of it, and in the U.K., it is in relatively short supply. We Brits have enjoyed an enduring love affair with property ownership, in particular since the 1980's and the introduction of the "right to buy."

One feature that has become increasingly significant for governments seeking to raise funds in the current climate is that real estate is immoveable. This is hugely significant in a world that has seen exponential growth in international mobility, both in terms of persons and assets.

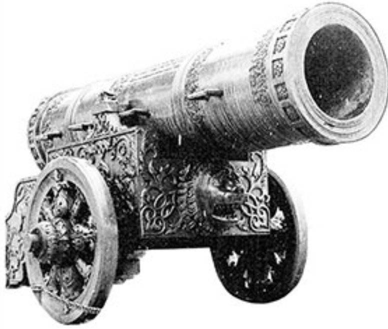
The global environment is increasingly mobile, yet taxing rights are fundamentally territorial in nature. Governments therefore compete with each other to attract mobile capital with occasionally aggressive competitive tax regimes and beneficial economic environments. The initiatives of supranational organizations, such as the E.U. and O.E.C.D., that look to provide for a fair allocation of taxing rights are increasingly important. However, the internal infrastructure and processes of these organizations are necessarily cumbersome, and the results, although astonishing under the circumstances, lag behind the changing economic landscape. In the interim, each government does what it can to tax what it perceives to be its fair share of the global tax base.

In this context, real estate is the dream asset – it is by its very nature immoveable. If an investor wants U.K. real estate, he or she will have to succumb to the U.K. tax

Naomi Lawton is a senior associate in the tax department of Memery Crystal LLP. Ms. Lawton advises businesses and individuals on a wide range of direct and indirect tax issues, both in the U.K. and internationally, and has advised on business structures, corporate acquisitions, disposals and reconstructions, real estate, and employment issues.

authorities. It is perhaps not surprising that the U.K. government wants to cash in on gains arising from this immovable asset.

THE GROWING TAX ARSENAL



What follows in this section is a gallop through some of the recent changes to the taxation of U.K. property, in chronological order (according to the date of entry into force of each). Although not exhaustive, the discussion addresses some of the more significant measures.

March 2012: S.D.L.T. on Enveloped Dwellings

The first of the recent fiscal assaults began in March 2012 with the higher rate of stamp duty land tax ("S.D.L.T.") for "enveloped" dwellings. Very broadly, S.D.L.T. is the tax that is paid by a purchaser on the acquisition of interests in property. It is payable at various rates on the "chargeable consideration" (generally equal to the purchase price).

At the time of the reform, the U.K. Conservative-Liberal Democrat coalition government was (and it appears the Conservative Party government still is) concerned with dissuading the acquisition and holding of real property by non-natural persons. In significant part, this was because the stamp taxes attributable to a transfer of shares in a company holding property (for example) are likely to be considerably less than the S.D.L.T. attracted by a transfer of the underlying property itself.

The effect of the changes was to increase the rate of S.D.L.T. to a flat 15% on the acquisition of residential property by a non-natural person. By comparison, the rates of S.D.L.T. for residential property at the time ranged from 0% to 7%. In the context of commercial or "mixed" property, the rate was (and still is) a flat 4%.[1] At the time that the changes were introduced, the provisions applied only to purchases where the chargeable consideration exceeded £2 million. The government could therefore assure its public that the measure would affect only the very wealthy.

Inevitably, however, the enemy settled in and spread out – mission creep. The threshold has now been significantly reduced so that the inflated rate applies to non-natural persons acquiring residential property with a value of £500,000 and over. In many parts of the U.K., £500,000 is a depressingly insignificant trigger point. Although there are a series of exemptions to the increased S.D.L.T. charge for acquisitions by non-natural persons, they are often complex and in some cases produce anomalous results.

APRIL 2013: A.T.E.D. AND A.T.E.D.-RELATED CAPITAL GAINS

A further attack came in April 2013 with the introduction of the Annual Tax on

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[1] These rates are quite high when compared to the acquisition of a comparable residential property in New York City. There, the city imposes a comparable tax of 1% of the value of the property (1.45% if the value exceeds $500,000), and the state imposes one tax on the seller of $2 for each $500 or fractional part thereof (essentially a tax of 0.4% of value) and a second tax on the purchaser of 1% when the value of the residential property exceeds $1 million.

Enveloped Dwellings ("A.T.E.D."). Again, the intention was to dissuade individuals from holding high-value residential property within a corporate structure. The effect of the A.T.E.D. is to impose an annual charge on enveloped dwellings, the quantum of which is linked to the value of the property. As above, although initially the charge applied only to properties worth in excess of £2 million, this threshold was soon reduced, and with effect from April 2016, it will be £500,000.

Although the introduction of the A.T.E.D. was intended to dissuade certain behaviors, the measure proved to be a far greater revenue generator than the government had anticipated. This seems extraordinary, given that the compelling but non-verified, anecdotal evidence indicates that the vast number of non-U.K. companies holding residential property knew nothing about the charge and non-deliberate non-compliance has been widespread. If government statistics are to be believed, the well of potential tax collections runs quite deep once the A.T.E.D. requirements are more widely known.

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Alongside the A.T.E.D., its brother was introduced – the A.T.E.D.-related capital gains charge. This is an extended capital gains tax on disposals of high-value residential property made on or after April 6, 2013 where the property is held in a corporate wrapper and is within the A.T.E.D.

December 2014: Overhaul of S.D.L.T. for Residential Property

In December 2014, the government announced a further package of reforms to the S.D.L.T. for residential property. The measures included some welcome simplifications (the end of the "slab" system of taxation, which resulted in unnecessary market distortions, was to be replaced by a progressive "slice" system), but also some less-welcome and eye-watering tax hikes, including a new top rate of 12% for acquisitions by individuals (the rate applicable to acquisitions by companies remains 15%). Again, the measures applied (and continue to apply) only to residential property.

April 2015: Capital Gains Tax on Residential Property for Non-U.K. Residents

In April 2015, the U.K. government introduced capital gains tax ("C.G.T.") for non-residents in respect of gains realized on U.K. residential property. This measure in particular represented a very significant shift in U.K. tax policy. Until then it had been a significant (and relatively unusual) feature of the U.K. tax system that it did not seek to impose capital gains tax in respect of U.K. property on non-U.K. tax residents. This had undoubtedly contributed to the popularity of the U.K. real estate market with offshore investors. However, the prevailing political climate meant that the economic clout of foreign investors (inevitably also non-voters) was easily eclipsed by political expedience.

April 2016: Additional 3% S.D.L.T. Rate for Second Homes

The most recently announced development (November 2015) has been the rather extraordinary and generally unforeseen announcement that the U.K. government would introduce an additional 3% S.D.L.T. surcharge on the purchase of additional residential properties (such as second homes and buy-to-let properties) for considerations exceeding £40,000, with effect from April 2016.

The announcement has been met with predictable outrage from the long-suffering property industry, together with a series of specific criticisms (not least in relation to the very rushed nature of the consultation), which has required a significantly shortened consultation period and a delay in the usual timetable for publishing the draft legislation.

Clearly the intention of the measure is to curb the rise of holiday home and buy-to-let properties. The proliferation of these properties is perceived to have caused damage to the local communities of certain areas. However, the measure goes much farther and has some rather surprising consequences. In particular, the government has confirmed that it is intended that the surcharge will apply to purchases by non-U.K. residents of a first home in the U.K. where that nonresident owns other homes worldwide. This is a pretty bold move in terms of the territoriality of a domestic tax measure. How the government intends to police this provision is unclear.

The government has also stated that married couples will be treated as a "unit" for the purposes of the legislation. Commentators have argued that this effectively penalizes married couples over cohabiting couples, since married couples will be treated as acquiring a second home and taxed accordingly, while unmarried couples may simply acquire a property each. The measure may also deter parents co-purchasing property with their children. This is an odd result for a Conservative Party measure and one which has inflamed the suggestion that the ill-thought-out consequences of some of the recent measures demonstrates a lack of coherent policy in this area. Certainly, the piecemeal and fragmented approach of recent announcements is unfortunate. Many of the measures have been forward-looking in any event, and it is not clear why the measures could not have been announced together.

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Predictably, there is some vigorous lobbying underway. It remains to be seen what form the draft legislation will be in when it is published in due course.

April 2017: Extension of I.H.T. to Indirectly Held U.K. Residential Property

Finally, as part of the 2015 Summer Budget, the government announced a number of significant reforms to inheritance tax ("I.H.T.") and the concept of domicile. Broadly, I.H.T. is a charge to tax primarily on an individual's estate on death. The rate is 0% on the nil rate band, 20% for any taxable lifetime gifts, and 40% on death. An individual who is domiciled in the U.K. is subject to I.H.T. on his or her worldwide estate. An individual who is not domiciled in the U.K. is subject to I.H.T. only in respect of his or her U.K. estate. Under current rules, U.K. property does not include shares in a foreign registered company, even where that company's only asset is U.K. land. However, with effect from 2017, "U.K. property" will include U.K. residential property, even where it is indirectly held through a foreign-registered and -resident company.

As was true for the extension of C.G.T. to non-residents, the change represents a very fundamental policy shift in the U.K.'s approach to the taxation of certain foreign nationals. Historically, the U.K. has provided an extremely hospitable economic climate to the foreign investor. The sands now appear to be shifting but only in respect of residential property, at least for the current time.

Residential vs. Non-residential: Why?

As is abundantly clear, a key feature of a number of the more penal tax developments is that they apply only to "residential" property. The economic consequences of finding that a property is residential in nature are therefore very significant. Not only will it dramatically affect the rates of S.D.L.T., it can also affect the incidence of the A.T.E.D., C.G.T., and I.H.T. Clearly, this puts huge pressure on the distinction.

So what does the term "residential property" mean? The definition largely turns on whether or not the land includes buildings suitable for use as a "dwelling." Specifically, property is regarded as residential if it comprises land and/or buildings

- used as a dwelling,
- suitable for use as a dwelling, or
- in the process of being constructed or adapted for use as a dwelling.

Note that for S.D.L.T. purposes, the higher rates apply only where the land transaction is comprised "entirely" of residential property. Where the property is mixed use (that is, it includes residential and non-residential property), the lower non-residential S.D.L.T. rates will apply.

However, the fact that part of what is otherwise a dwelling is used for business purposes does not necessarily result in a finding that the property is not residential. The key question is whether the building is suitable for use as a dwelling. The distinction is not always an easy one to make. By way of example, a five-bedroom farm house with 20 acres used for commercial agricultural purposes would be mixed use and would qualify for the lower rates. On the other hand, the same house with 20 acres of parkland and the neighbor's chickens on the field at the bottom of the drive might not.

Inevitably, a number of so-called "tax planning" schemes (some more accurately described as fairytales) seek to exploit this distinction. Some of the schemes are eye-wateringly creative and undoubtedly ineffective. We can expect increasing H.M.R.C. scrutiny in this area.

What is not clear is why the U.K. government has chosen to impose such different fiscal treatment on the basis of a distinction that is in some cases both arbitrary and esoteric, and more importantly, difficult to predict. What is it about residential property that justifies this disadvantageous treatment? Many other jurisdictions do not make the distinction at all in terms of tax treatment.

THE LAFFER CURVE

Tax specialists are sometimes reputed to be inaccessible and nerdy. (I believe my U.S. friends refer to this as "dweeb-like.") This is plainly an absurd proposition, and one which I am loathe to promote by including abstract references to academic constructs without practical purpose. Instead, I will refer simply to the Laffer Curve.

The Laffer Curve demonstrates, in diagrammatic form, the behavioral economics principle that increasing the rate of tax does not continue to result in higher tax yield; indeed, the converse is true. Although increases in rates of tax at certain levels may increase total tax take, at some point, an increase in the rate will dis-incenti*vize*

the activity producing the asset. At one end of the spectrum (the beginning of the curve), the tax rate is zero, as is tax take. There may be plenty of economic activity, but no tax is levied on it. On the other side of the curve (the end), the tax rate is 100%, and the tax take is also zero. The tax rate has extinguished economic activity. This is referred to, at times, as making others pay their "fair share" of tax.

The peak of the curve is the holy grail of good tax policy. It represents the maximum level at which a government can tax any particular activity before dis-incenti*vizi*ng it to levels at which tax yields decrease. In other words, it is important to tax (in this case) property investors until Lord Healy's pips squeak, but not to continue to do so to the point of a thermonuclear explosion.

Clearly, the U.K. government feels that the U.K. real estate sector is sufficiently robust to withstand the recent fiscal assaults. In other words, it believes that the Laffer Curve applicable to residential property is still in its ascendancy. However, at some point, the zenith will be reached. What then? And who will benefit at that time? Most likely, it will be the ultra, ultra-wealthy, as only they will be immune from the tax increase.

THE REAL, IMPRECISE, AND IMPERFECT WORLD

However, economics is not the only driving force behind tax policy. Tax policy does not operate in an academic vacuum. Rather, it is formed in a rather more real, imprecise, and imperfect world, in which rather more real, imprecise, and imperfect politicians (with varying degrees of intellect, personality, and competing motives) jostle for power and position, and the maximum length of fiscal foresight tends to be pretty much around the five-year mark.

In this rather more real, imprecise, and imperfect world, tax policy makers must make decisions about who, what, and how much to tax in response to any number of domestic and global economic, social, and natural events. They must then defend these positions to the media, the lobbyists, and the ever-powerful court of public opinion. Budget Day announcements undoubtedly often owe more to extravagant political posturing than to the Laffer Curve.

As mentioned above, one of the more frequent criticisms of the recent changes has been their fragmented and piecemeal development. Where is the reasoned and coherent tax policy? However, it may be that in this rather more real, imprecise, and imperfect world, it is unrealistic and even undesirable for governments to impose rigid long-term fiscal policies. Instead, it may be that an iterative approach is the ideal. It allows policymakers to respond to the changing economic and social factors and the vagaries of the tax take. Which is not to say that policymakers should abandon efforts to design and pursue a careful and coherent tax policy, but neither should they be restricted from reacting appropriately to necessity and expedience.

The U.K. enjoys a hugely successful property industry. Under the circumstances, perhaps it is not surprising that the U.K. government has sought to exploit that fact.

WHERE TO NOW?

How is the market to make sense of it all? Clearly, the taxation of real estate in the U.K. is a fast-moving and increasingly specialized area. The intricacies of many of

the relevant taxes proliferate, and their interactions can be difficult to quantify in advance. Who should invest, in what form, from what jurisdiction, and in accordance with what terms? How should the property be used? The tax practitioner may find that it is best to be agile in planning, including flexibility in that investment structures so that they may be modified on the fly in response to changes of policy.

It remains to be seen whether some of recent residential property developments will be extended to commercial and mixed property. It is also possible – maybe even likely – that the government will seek to tinker with the definition of residential property or remove it entirely.

Meanwhile, it is perhaps not surprising that we are seeing an increased appetite for investment in commercial property.

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