U.S. INVESTMENT IN U.K. REAL ESTATE INVESTMENT – SEPARATED BY A COMMON LANGUAGE

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Tags
C.G.T.
Corporation Tax
I.H.T.
L.T.R.
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U.K.

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INTRODUCTION

The focus of this article is the U.K. tax treatment of direct or indirect investments in U.K. commercial real estate made by wealthy individuals, particularly U.S. residents. It begins with an overview of the principal U.K. tax issues for non-U.K. residents, focusing on capital gains tax ("C.G.T."), corporation tax, and inheritance tax ("I.H.T."). It then provides illustrations on how those tax rules apply in practice, focusing on two common fact patterns used by U.S. persons.

It is common for investors to own commercial real estate through a company rather than owning real estate directly, and to hold each property through a separate special purpose vehicle ("S.P.V."). What follows is based on this commercial practice.

OVERVIEW – U.K. TAXATION OF DOMESTIC COMMERCIAL REAL ESTATE

C.G.T. and Corporation Tax

Since April 2019, non-U.K. resident individuals are subject to C.G.T. on gains realized on disposals of directly held U.K. commercial real estate. The gain is calculated by deducting the base cost and allowable expenses from the consideration that is received in the transaction. The tax rate for individuals is progressive and is capped at 24%.

The scope of C.G.T. was extended in April 2019 to cover gains realized on the disposal of indirect interests in U.K. land, in particular the disposal of shares in a property-rich company. Any gain realized on the disposal of shares in a property-rich company can be taxed at up to 24%. Broadly speaking, a company is considered to be property-rich once 75% of its value is derived from U.K. land, which includes interests in both U.K. commercial property and U.K. residential property.

Where a company owns U.K. real estate, it is liable to corporation tax at 25% on profits realized on the sale of the underlying property. While holding real property, a company is taxed on rental income at the same rate. As with trading income, the profits of a property business are calculated in accordance with generally accepted accounting practice. Expenses such as repairs and maintenance as well as management and agent fees are generally deductible. But there are restrictions. For example, expenses of a capital nature such as capital improvements or those not incurred exclusively for the purposes of the property business are excluded. Certain categories of plant and machinery, such as heating and ventilation systems, may attract tax relief as capital allowances.

In the cases above, if the U.K. real estate or interest in a property-rich company that is being sold was acquired before April 5, 2019, the base cost is increased to the value as at April 5, 2019.

I.H.T.

The U.K.'s non-dom regime was abolished on April 6, 2025, so domicile no longer determines an individual's liability to I.H.T. Instead, tax exposure depends on three factors:

- The first is whether the individual is a long-term UK resident. ("L.T.R.").
- The second is the situs of the property.
- The third, which is only relevant to non-U.K. situs property, is whether the property derives its value directly or indirectly from UK residential property.

Broadly, an individual is an L.T.R. if he or she were a U.K. resident in ten out of the preceding 20 tax years. Note that the U.K. tax year runs from April 6th to the following April 5th. Since 2013, a statutory test that is largely formulaic determines the residence of individuals.[1]

An L.T.R. is liable to I.H.T. on worldwide assets. But an individual who is not an L.T.R. is chargeable to I.H.T. in regard only to U.K. situs assets and non-U.K. situs assets to the extent that they derive their value from U.K. residential property. From April 2017, U.K. domestic rules prevent the estate of an L.T.R. from shielding the value of U.K. residential property from I.H.T. by holding it through a non-U.K. company. These rules do not extend to U.K. commercial property held through a non-U.K. company.

Whether or not the decedent is an L.T.R., the estate of the decedent is entitled to a tax-free allowance of £325,000, known as the "nil-rate band." On death, an individual's estate is subject to I.H.T. imposed at a flat rate of 40% on the value of any directly owned U.K. commercial real estate that exceeds the nil-rate band. In contrast, commercial real estate held indirectly through a non-U.K. company is not subject to U.K. I.H.T. provided the decedent was not an L.T.R. as of the date of death.

Stamp Duty Land Tax ("S.D.L.T.")

The S.P.V. as the buyer would be liable to S.D.L.T. on the purchase of commercial real estate. S.D.L.T. is calculated using the "slice system," a form of graduated tax. Commercial real estate is subject to S.D.L.T. at a 0% rate on the value up to £150,000. Thereafter, the rate is 2% on the value up to £250,000, and 5% on the value exceeding £250,000. To illustrate, S.D.L.T. for a commercial property with a purchase price of £10,000,000 is £489,500.

Payment of S.D.L.T. is due within 14 days of the earlier of (i) the date of completion

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[1] The detail of the test is beyond the scope of this article. In short, there are tests that can result in an individual being automatically nonresident or resident. For example, an individual is automatically U.K. resident if 183 days are spent in the U.K. If none of the automatic tests apply, whether an individual is U.K. resident is determined by reference to the number of specific ties that exist to the U.K., such as whether (i) at least one night is spent in an accommodation that is available to the individual for a minimum of 91 days during the tax year and (ii) the number of days spent in the U.K. by the individual.

or (ii) the date on which the contract is "substantially performed" (*e.g.* if the buyer takes occupation to do works on the property prior to completion).

Value Added Tax ("V.A.T.")

"Opting to tax" is an election that the owner of commercial or rental property can make to charge V.A.T. on the lease or sale of commercial property, which would otherwise be exempt from V.A.T. This allows the business to recover the V.A.T. it incurs on costs related to the acquisition, improvement, and operation of the property. Once made, the option to tax remains in effect for 20 years and can be revoked in limited circumstances, only.

Before purchasing a property, the buyer should confirm whether the seller has opted to tax with regard to a commercial property. If the property were opted, the buyer would pay V.A.T. on the purchase price. As a result, the buyer would pay S.D.L.T. on the total amount paid, which would include the purchase price and V.A.T. on that purchase. Therefore, this can result in an increased cost across two taxes. However, if the buyer provides goods or services that are V.A.T. chargeable, the V.A.T. incurred on purchase may be recoverable, but the S.D.L.T paid on that V.A.T. is not recoverable.

The buyer will also need to consider whether it wishes to opt to tax the property when renting it out. While this can enable it to recover V.A.T. costs associated with operating a property rental business, some tenants cannot recover V.A.T., including tenants in the financial sector, charities, and healthcare providers. They would find V.A.T. charges on rent unattractive.

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Ordinarily, no V.A.T. charges apply if either (i) the seller has not opted the property or (ii) "transfer of a going concern" treatment applies. For the latter to apply, the buyer would need to purchase a property rental business and continue the rental business thereafter.

OVERVIEW – U.K.-U.S. INCOME AND ESTATE TAX TREATIES

Determining the most appropriate investment structure may be influenced by whether an individual is able to benefit from relief under the U.S.-U.K. Estate and Gift Tax Treaty ("the Estate Tax Treaty") for transfer tax purposes (including I.H.T.) and the U.S.-U.K. Income Tax Treaty ("the Income Tax Treaty") in respect of income tax, corporation tax and C.G.T.

The Estate Tax Treaty

The Estate Tax Treaty can limit an individual's exposure to I.H.T. In general, the Estate Tax Treaty grants the country of domicile the right to tax the worldwide assets of an individual, and credit is given for estate tax paid in the other country where real estate and business property of a permanent establishment are located. However, there is a saving provision which allows the country of an individual's nationality to continue taxing the individual. This provision can significantly restrict the treaty relief that is available to dual nationals.

Note that following the abolition of the non-dom regime, an individual's exposure to I.H.T. depends on whether he or she is an L.T.R. The U.K. legislation enacting the changes confirms that references to domicile in the U.K.'s I.H.T. treaties should be read as referring to an individual who is an L.T.R.

For example, an individual domiciled in the U.S. who is not a U.K. citizen would not be exposed to I.H.T. on shares in a U.K. company, but would be liable to I.H.T. on U.K. commercial real estate that is owned directly. In comparison to the Income Tax Treaty, the Estate Tax Treaty does not extend the definition of immovable property to include shares in a property-owning company.

As will be explored below, it is also possible for a U.S. domiciled individual who is not a U.K. citizen to form a trust that shields its assets other than U.K. real property and business property of a permanent establishment from I.H.T.

The Income Tax Treaty

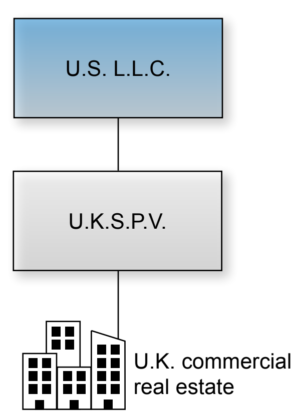
Under the Income Tax Treaty, the U.K. is entitled to tax gains realized by a U.S. resident on the disposal of real property located in the U.K. Further, in contrast to the Estate Tax Treaty, the U.K.'s taxing rights extend to shares in a company that derives its value directly or indirectly from U.K. real property.

The Income Tax Treaty provides that gains from disposals of U.K. real estate subject to tax in the U.K. are treated as income from a U.K. source. Foreign tax credits will therefore be allowed by the U.S., although this will be limited to the amount of U.S. tax imposed on the foreign source income.

The U.K. is allocated primary taxing rights under the Income Tax Treaty on rental income from U.K. commercial real estate. A credit for the U.K. tax may be available in the U.S.

EXAMPLES

Two-Tier Ownership – U.S. L.L.C./U.K. S.P.V.



In the above example, U.S. residents own U.K. commercial real estate through a two-tier structure. In particular, the U.S. residents hold interests in a U.S. limited liability company ("U.S. L.L.C."), which in turn owns all the shares in a U.K. private limited company ("U.K. S.P.V.") that holds the U.K. commercial real estate. We have assumed that the U.S. residents are U.S. citizens that are neither U.K. citizens nor L.T.R.'s.

It is likely that the U.S. resident individual will follow the default treatment of U.S. L.L.C.'s and file an income tax return treating the L.L.C. as tax transparent. This would enable the investor to be taxed only at the individual level.

Similarly, the U.S. resident individual would probably elect for U.K. S.P.V. to be treated as a partnership for U.S. income tax purposes. A U.K. incorporated company is preferred because one incorporated in the U.S. would not be able to elect for pass-through treatment under the check-the-box rules. If the election were not made, the U.S. may regard the U.K. S.P.V. as being a corporation that is a C.F.C. or P.F.I.C., and therefore subject to less favorable tax treatment under U.S. tax rules. Electing for the U.K. S.P.V. to be treated as a pass-through entity enables U.S. investors to claim a credit for a proportionate share of U.K. income taxes. This election does not impact the U.K. tax treatment. If an actual partnership were desired to hold the shares in U.K. S.P.V., a U.S. partnership might be preferred because U.S. partnerships are not subject to the U.K. regulatory rules on entities that constitute collective investment vehicles.

Companies incorporated in the U.K. are automatically U.K. resident. U.K. S.P.V. is treated as opaque by the U.K.'s H.M. Revenue & Customs ("H.M.R.C.") and the U.K. does not have a check-the-box regime. Therefore, income and gains are taxed at the level of U.K. S.P.V. It will be subject to U.K. corporation tax at a rate of 25% on profits relating to (i) gains realized on a disposal of the commercial real estate, and (ii) rental income. There is no withholding tax on the payment of dividends from U.K. companies.

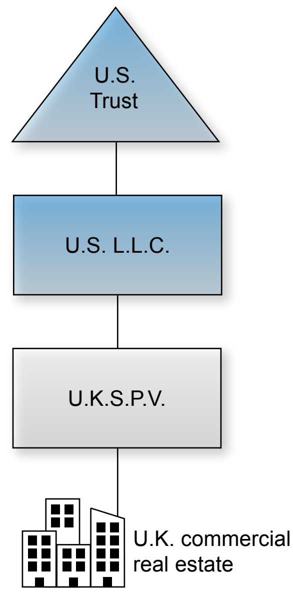
It is generally considered optimal to have a separate S.P.V. for each property – on an onward sale, a purchaser of the shares in U.K. S.P.V. will pay stamp duty (at 0.5%) rather than S.D.L.T. on the transaction.

On a disposal by the L.L.C. of shares in the U.K. S.P.V., the L.L.C. will likely be subject to corporation tax at 25% on any gain because H.M.R.C. treats U.S. L.L.C.s as opaque entities. The investors in the U.S. L.L.C. would claim a tax credit for a share of the U.K. tax paid under the Income Tax Treaty.

If the investor in U.S. LLC were not an L.T.R. there should be no I.H.T. exposure because the interest in U.S. L.L.C. should have a non-U.K. situs. We do not need to rely on the Estate Tax Treaty because, unlike U.K. residential property, the situs of U.K. commercial real estate can be blocked by holding the property through a non-U.K. entity. In the alternative, if the investor held shares in U.K. S.P.V. directly, the Estate Tax Treaty would assist, assuming the U.S. investor were U.S. domiciled and not a U.K. national. Under the Estate Tax Treaty shares in U.K. S.P.V. should not constitute immovable property or business property of a permanent establishment.

As to the financing of U.K. S.P.V.'s purchase, interest payable on a commercial loan secured on the property should, normally, be deductible for the purpose of calculating U.K. corporation tax, subject to the U.K.'s rules that can restrict deductibility where a company or a group of companies has net interest and financing costs of over £2 million in a 12-month period. Advice should be obtained if this is likely to be an issue.

Three-Tier Ownership – U.S. Trust/U.S. L.L.C./U.K. S.P.V.



In this example we have varied the ownership structure to include a U.S. trust as the owner of the interests in U.S. LLC. We have assumed that the trust is irrevocable and is U.S. resident. We also assume the settlor is a citizen and domiciliary of the U.S. and is neither a U.K. national nor an L.T.R.

The trustee of a non-U.K. tax resident trust should not be subject to U.K. tax on the trust's non-U.K. income and gains. Any U.K. resident beneficiaries would be subject to tax on a benefit received from the trust, including rent-free use of real estate. If the trust were settlor-interested and the settlor were U.K. resident, the trust's worldwide income and gains would be treated as arising to the settlor and subject to tax in the U.K.

Here, there is the potential for double taxation where both the grantor or trustees are liable to U.S. tax on the trust's income and gains and there are U.K. resident beneficiaries who receive a benefit from the trust. For example, if the trust were grantor for U.S. income tax purposes, the U.S. grantor might be chargeable to U.S. tax on the trust's income and gains as they arise, but the beneficiaries would only be liable to U.K. tax on receipt of a benefit such as a distribution. Advice should be obtained on the options for managing this exposure to double tax.

Below the level of the trustee, the U.K. tax implications are the same as in the first example. If the trustee disposed of its interests in U.S. L.L.C. it would be subject to C.G.T. at up to 24% on any gain, and a credit may be available in the U.S. for such U.K. tax.

As for I.H.T., an individual who is U.S. domiciled and not a U.K. national may be able to rely on the Estate Tax Treaty to form a trust that shields assets other than U.K. immovable property and business property of a U.K. permanent establishment from I.H.T. Based on the assumptions made above about the settlor, the Estate Tax Treaty should ensure that the trust's interests in U.S. LLC in this second example are not exposed to I.H.T.

There are of course many permutations to the above examples and advice should be taken in both jurisdictions when setting up the investment structure.

CONCLUSION

George Bernard Shaw is attributed the saying that England and America are two countries divided by a common language. While he may have been referring to cultural and linguistic differences, the saying is equally true with regard to income and estate tax consequences that apply when U.S. investors plan for the acquisition of commercial real estate in London. But with guidance on both sides of the Atlantic, the differences can be managed.

"There are of course many permutations to the above examples and advice should be taken in both jurisdictions when setting up the investment structure."