FACT SHEET

TAX PLANNING FOR UK PROPERTY DEVELOPMENT BY OVERSEAS INVESTORS

For the overseas investor looking to generate planning gains or development gains from UK real estate, offshore tax planning continues to play a significant role.

For the purposes of this article, "overseas" includes both non-resident and UK-resident/foreign-domiciled persons, although for the latter group there are additional anti-avoidance measures to take into consideration.

The starting point, and this is often a surprise to some investors, is that transactions involving planning gains or development gains are treated as "trading profits", rather than as "capital gains". The latter, of course, would generally be exempt from tax when generated by an overseas investor. In situations where the developed land is to be retained and held as an ongoing investment to generate rental income, it is possible to avoid the "trading" tax treatment.

SHELTERING PLANNING GAINS

Where land is acquired with a view to adding value through the procurement of planning permission, and then sold to a developer, it is possible to shelter the resulting uplift in value by using a Guernsey resident company. Under the provisions of the current Guernsey/UK double taxation treaty, trading profits of a Guernsey-resident company are only taxable in Guernsey (which has a zero rate of corporation tax), provided that the company does not generate the trading profits from a permanent establishment in the UK.

Merely owning land, or an option over land, does not constitute a permanent establishment. Therefore, the Guernsey-resident company can buy the land, or options over the land, obtain planning permission, and then sell the land or options to another party for a profit without that profit being taxable in the UK. The trading profit would be taxable in Guernsey, but at a zero rate.

HMRC's main angle of attack against the use of such planning would be to argue that the Guernsey company was not in fact resident in Guernsey, and therefore not entitled to take advantage of the double tax treaty. It is not sufficient to merely demonstrate to HMRC that the Guernsey company is not resident in the UK under "central management and control" principles. Accordingly, the board of directors of the Guernsey company must robustly demonstrate that it, and it alone, makes all board decisions. A “brass-plate” offshore board will not suffice. In order to clearly demonstrate that the Guernsey-resident board contains appropriate property expertise, PraxisIFM appoints a Guernsey-resident chartered surveyor or architect to the board of all Guernsey companies engaged in UK planning or land development projects. This comes, of course, at a cost but it is a false economy to cut corners.

Once planning consent has been obtained, it is common for the Guernsey company to sell the land to a developer. This might be an unrelated third party buyer or an associated company. If the latter, then the sale must be on arms-length commercial terms. SDLT group relief should be available. The sale of the land will crystallise the planning gain and this gain should be protected by the double tax treaty, with no tax payable either in the UK or in Guernsey.

It is necessary for the Guernsey company to formally claim relief under the Guernsey/UK double tax treaty as relief is not automatically available.

MITIGATING TAX FROM DEVELOPMENT GAINS

HMRC's current view is that when a Guernsey-resident (or Jersey or Isle of Man) company creates a building site in the UK, it creates a permanent establishment and all trading profits attributable to that permanent establishment are subject to UK Income Tax (note, not

Corporation Tax) at the basic rate of 20%. This is despite the Guernsey/UK double tax treaty not stipulating a specific period after which a building site is deemed to be a permanent establishment (unlike many other treaties which stipulate a 6-month, 12-month or 24-month period). Technically, this stance by HMRC is arguable, but few developers these days are willing to get embroiled in a long and extensive battle with HMRC. Even where the Guernsey developer company engages an independent UK contractor on a "design and build" contract, an argument over the Guernsey company's residency status (see below) is likely to brew.

HMRC will invariably look to exploit the fact that many developers are "hands-on" businessmen, who do not readily wish to defer to offshore directors when making key development decisions. If the developer happens to be UK resident, then HMRC will often claim that the UK resident rather than the offshore board is really calling all of the shots, and so would look to argue that the Guernsey company is therefore resident in the UK (perhaps as well as in Guernsey), and so its profits should be assessable to Corporation Tax, irrespective of arguing the permanent establishment point.

So, why get embroiled in an HMRC battle? In our view, in respect of land development gains it is simply not worth the hassle. Instead, we would suggest that it is far more prudent to accept an exposure to UK tax on the development gains, but to try to reduce the net effective rate of tax to somewhere around the 10% level. To many clients, that is very acceptable.

So how can this be achieved?

Firstly, the land development is carried out by a company which is UK-resident for Corporation Tax purposes, i.e. it is managed and controlled in the UK by UK-resident directors. This makes so much practical sense anyway, because the directors do not then need to seek approval of proposed decisions by an offshore board.

This UK-resident company need not be a UK-incorporated company. Indeed, for a foreign-domiciled client there are advantages to using a company which is incorporated in, say, Guernsey, but managed and controlled in the UK by a fully UK-resident board, because for capital taxes purposes (both UK Capital Gains Tax and Inheritance Tax), the company's shares would be deemed to be foreign-situs.

Secondly, it must be accepted that the net assessable profits will be subject to UK Corporation Tax. Rates are currently sliding down towards 21% by tax year 2014/15. The development profit will generally be realised in the tax year in which the land is eventually sold, and the cost base to the development company will consist of its initial purchase price, plus the development costs, plus all allowable loan interest.

Thirdly, all arms-length loan interest paid will be an allowable expense. This is a very complex area because the rate of interest must be at a market rate, and on the same terms as would be available between unrelated parties. Therefore, if the overseas client is able to fund the costs by way of a loan of his/its own resources, as opposed to using commercial finance, then this can be extremely effective.

What is a market rate? After all, banks are very rarely lending in the current climate to finance development projects. Most loans currently are from other specialist lenders, usually lending at mezzanine-type rates. That, in practice, is a "market rate". It is highly advisable to engage an accountancy firm to confirm this in order to satisfy transfer pricing rules, but a rate of interest of somewhere between say 12% and 18% per annum is fairly common at the time of writing (December 2013). Assume a rate of 15% per annum compounded for 3 years to fund a 3-year site development. Interest is rolled-up because the developer has no sales revenues from which to pay the loan interest during the development stage. For each £1 million lent at 15% per annum and compounded for 3 years, roughly £520,000 of loan interest will have accrued by the end of the period, i.e. 52%. That full amount, once eventually paid, should be fully deductible for Corporation Tax purposes, thereby reducing the effective net rate of tax considerably. Of course, an arms-length lender is unlikely to lend more than around 65% to 70% of the development costs, and at mezzanine-type rates a borrower would not find it viable to see so much of the projected development profits go to a third party lender, so the loan-to-value ratio will also form part of the transfer pricing advisory process.

In principle, when a UK-resident borrower pays interest to a non-resident lender, the borrower must withhold basic rate tax of 20% and pay it over to HMRC. If the lender is resident in a country which has a suitable double tax treaty with the UK, then this withholding tax can be reduced or even sometimes avoided.

However, if the loan is structured as a Eurobond and listed on a recognised overseas stock exchange, then the loan interest can be paid gross, without any tax being withheld. Similarly, if the loan is instead structured as a Deep Discounted Security, with a "premium" (or discount, as applicable) then the "premium" is currently not subject to withholding tax and so can also be paid gross. Some financing arrangements are structured via Luxembourg financing companies to get the "belt and braces" protection of a Eurobond exemption and an exempting double tax treaty. These types of structure are commonplace, although they are starting to come under scrutiny.

The net effect is that the overall tax rate from the land development itself can be reduced considerably down from the headline Corporation Tax rate, with a sizeable proportion of the profits being able to be paid gross to overseas investors. Of course, the profits may well still be taxable in the overseas investor's country of residency, so advice needs to be taken on a case-by-case basis.

If the planning gains have also separately been sheltered from UK tax, then for the overseas client the end result can be extremely attractive. Paying a modest effective rate of UK tax on just the development element of the gains seems a prudent approach, and is far less likely to attract the special attention of HMRC because some taxes are being paid. In this new tax planning era, our view is that trying to avoid tax altogether is not a wise strategy.

NEXT STEPS

PraxisIFM does not provide the specific tax advice for these tax planning structures, but can introduce clients and potential clients to specialist advisors who provide such advice on a daily basis. Bespoke Tax Counsel's advice can also be arranged.

PraxisIFM can set up and administer the relevant Guernsey (and any other offshore) companies, as well as any Luxembourg financing vehicles. We can also assist with introduction to UK firms of accountants who can handle all requirements relating to UK-resident companies.

Fees will always be quoted on a case-by-case basis, as every planning/development structure has separate characteristics. Wherever possible, we aim to quote fees which are:

- Fixed (within pre-agreed parameters once the exact scope of work is known)
- Transparent (with no hidden costs, commissions or retrocessions)
- Flexible (we are always willing to consider alternative fee proposals).

OTHER SERVICES

PraxisIFM is able to source loan finance for planning projects and development projects, including mezzanine finance, from specialist lenders.

We can also assist with Guernsey and UK tax compliance services for the property structures.

CONTACT

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