TaxTalk

Simplifying the complexities of Tax

Autumn 2024

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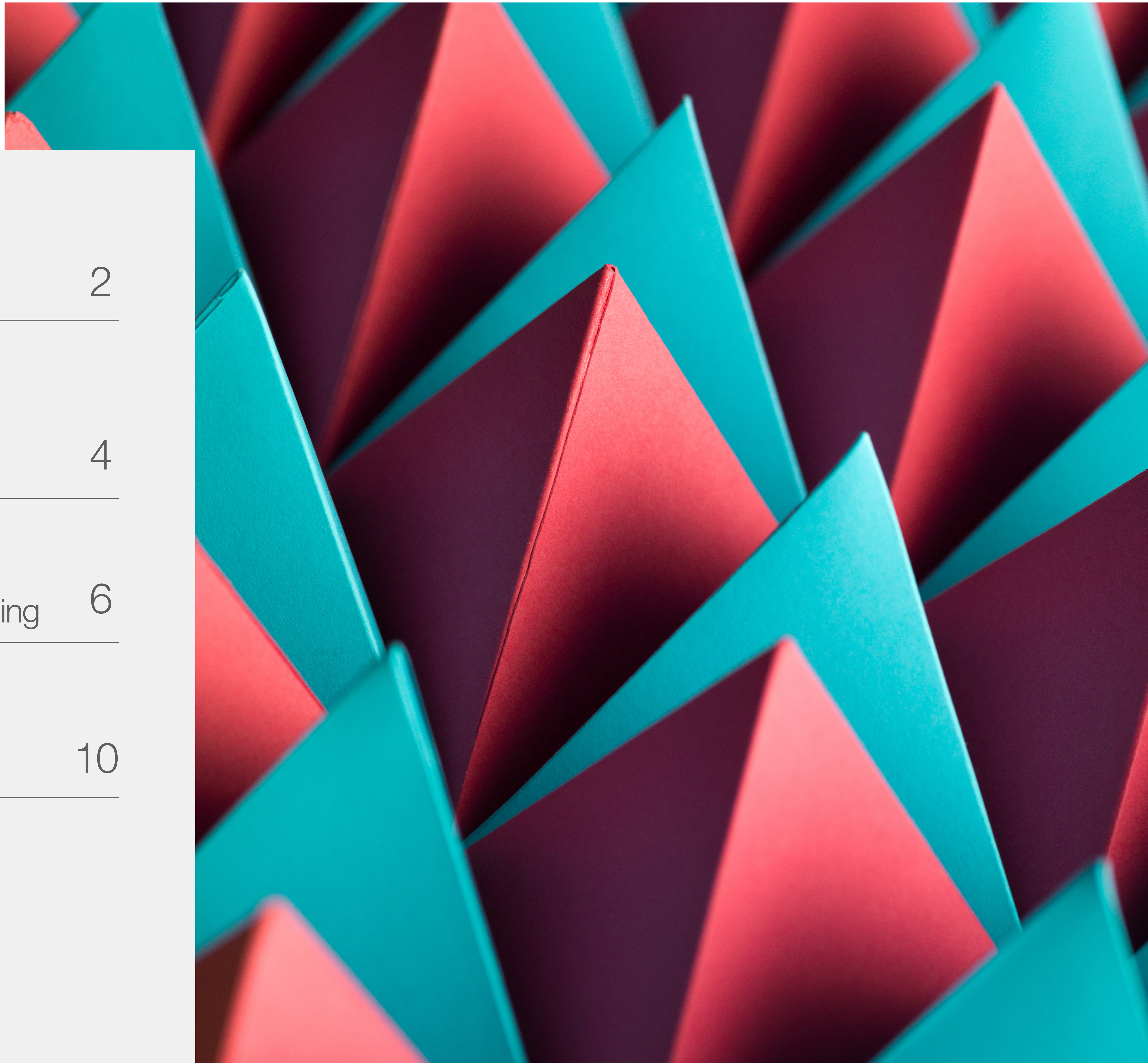

Taxing interest: the hidden cost for UK property investors

Overseas financing when buying a UK property may not be as simple as you think.

Cross-border financing arrangements used to acquire UK property can carry a hidden cost of up to 20% if investors fail to consider the UK withholding tax (WHT) rules carefully. These rules are complex, and a common but risky assumption is that they only apply to UK incorporated companies. But in reality, non-UK corporate investors are just as likely to be affected. Overlooking the detail of the WHT rules can be costly.

Real estate investments are typically highly geared due to the capital-intensive nature of the sector. They often require significant upfront funding.

When overseas investors want to acquire UK property, they may rely on cross-border funding through intra-group loans or external sources like banks. In such cases, where interest payments (or interest equivalents) are deemed to 'arise' in the UK, borrowers must consider the application of UK WHT rules.

What to expect from HMRC

There's a risk that HMRC may argue the overseas financing is deemed to have a UK source and is therefore considered to arise in the UK. This is because often the corporate borrower's sole income generating asset is its UK property, for which it receives UK rental income.

The WHT mechanism aims to secure tax revenue for HMRC earlier and mitigate the risk of non-declaration by recipients. The standard UK WHT rate is 20%, but in certain scenarios it can be reduced right down to 0%. The borrower is responsible for ensuring compliance, so any failure to withhold tax may mean HMRC charges interest and imposes penalties.

Most external loan agreements include a clause saying that if the lender incurs tax costs, such as WHT, the borrower must indemnify this cost by increasing the interest payments to a grossed-up figure. So the cost of borrowing can rise significantly.

What exemptions might apply?

As there's a real danger of increased borrowing costs, it's crucial to explore available tax reliefs and exemptions before entering any new loan agreements. These reliefs can be complex, so we recommend seeking professional advice.

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Here are some commonly used exemptions:

- UK branch of an overseas bank. Payments of interest to the UK branch of a foreign bank relieve the borrower of WHT obligations
- Non-yearly interest payments. Although not clearly defined in legislation, interest that is not yearly generally refers to loans with a duration of less than a year. But this definition can be contentious, requiring professional advice
- Private placement exemption. This is particularly useful when a double tax treaty (DTT) between the UK and the third party lender's jurisdiction does not reduce WHT to nil. Strict conditions must be met for the debt to qualify
- Qualifying asset holding companies. Payments made by these entities may be exempt from WHT
- Quoted Eurobond Exemption. Interest on a quoted Eurobond may also qualify for exemption.

Borrowers may be able to benefit from other exemptions and mitigations if none of the 'domestic' provisions apply, some of which are listed above.

In some scenarios the basic rate of WHT (20%) may be reduced under the terms of the relevant DTT. But it's essential to review the applicable treaty and apply to HMRC for relief at source before making any interest payments.

For a review of your current cross-border financing arrangements, advice on upcoming agreements, or help with HMRC treaty applications, please contact Harry Gooch.

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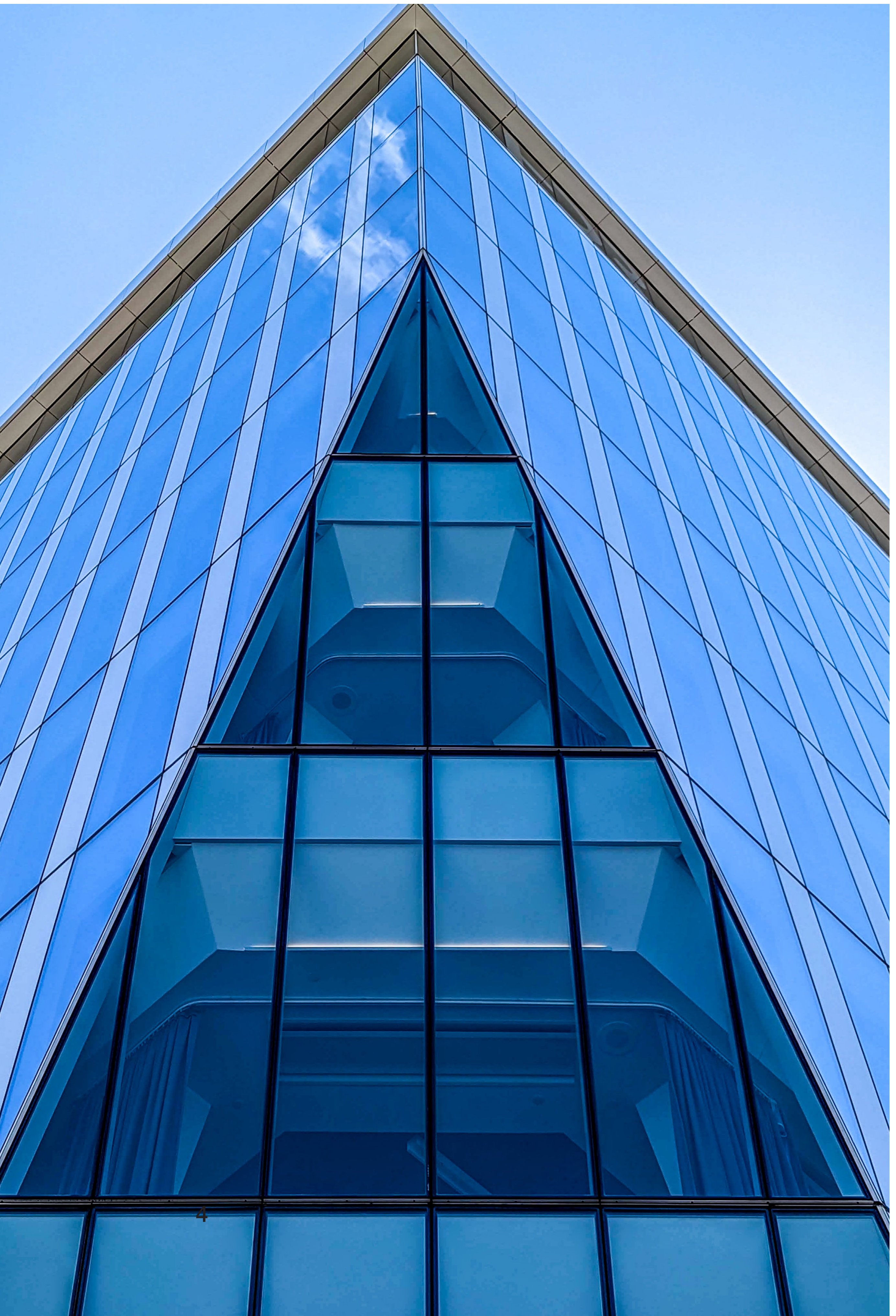
Chip off the old VAT block: understanding the zero VAT rate for construction

We outline the importance of understanding the zero VAT rate for those involved in the construction and the residential property industry.



Businesses involved in the construction and supply of buildings used for residential purposes often assume that their supplies are entirely or predominantly subject to the 0% VAT rate.

The reality is far more nuanced and this article highlights examples of the areas that, in our experience, are frequently misunderstood or misinterpreted (particularly in the care home sector).

Summary of the relevant rules

I could fill up an encyclopaedia with the regulations and case law surrounding the zero rate for qualifying buildings; HMRC's VAT Notice 708 however, does a stellar job of diving into the detail.

For the purposes of this article, the following is key:

1. The service of constructing a new building generally attracts VAT at the standard rate (currently 20%). However, where the construction services relate to certain new qualifying buildings, the zero rate may apply.
2. The first sale of, or the first grant of a long lease in, a new qualifying dwelling or communal residential building by the person constructing it also may be eligible for zero-rating.

Qualifying buildings include:

- A building designed as a dwelling
- A building that will be used solely for a relevant residential purpose (e.g. a care home)

3. In order for a builder to zero-rate its construction of a building to be used solely for a relevant residential purpose, the builder must receive a certificate from the end-user confirming that this is the case.
4. In order for a developer to zero-rate its first sale, or its first grant of a long lease in, a building that will be used solely for a relevant residential purpose, this builder must receive a certificate from the purchaser / lessee confirming that this is the case ahead of the sale / lease.

Issue 1 – What happens when construction services are not supplied to the end-user?

This frequently occurs in the care home sector. The industry typically implements a structure whereby an investment company ("PropCo") incurs all the land and construction costs for a new care home. PropCo subsequently grants a long lease of the new care home building to a care home operating company ("OpCo").

Here, the recipient of the construction service, (PropCo) is not the end-user of the building and therefore cannot certify that the building will be used for a solely relevant residential purpose. Consequently, the builder does not have the option to zero-rate any element of its construction services and must charge 20% VAT on all its services. This creates a cash flow cost in the investment company and we recommend filing VAT returns on a monthly basis to help manage this issue.

Issue 2 – Can developers recover all the VAT incurred on care home construction and fit out costs?

The short answer is no. VAT recovery in this scenario can get very complicated and we are often called upon to clean up the mess when VAT has been over-recovered or under-declared and a significant disclosure to HMRC is necessary.

Chip off the old VAT block: understanding the zero VAT rate for construction

As outlined above, the first grant of a major interest (e.g. a lease of more than 21 years in England) in a qualifying relevant residential building (such as a care home) by the person constructing it (PropCo) can in principle be zero-rated. If all the conditions are met (certificates etc), the VAT incurred by PropCo on the construction costs should in principle be recoverable because the VAT incurred directly relates to its 0% VAT rated supply to OpCo.

However, the VAT legislation specifically blocks recovery of VAT on certain incorporated goods (e.g. carpets, most fitted furniture) when the VAT incurred relates to an onward zero-rated supply. In our experience, PropCos routinely do not apply the blocking rules correctly resulting in an over-recovery of VAT. This is not entirely surprising as the builders' construction invoices either do not identify the items that should be blocked from VAT recovery or do so incorrectly. PropCos are then left with the onerous task of identifying the goods that were incorporated into the building and then analysing which incorporated items do not qualify for VAT recovery.

Furthermore, where non-incorporated loose items are included as part of the long lease (e.g. tables, chairs, beds, electrical items), VAT incurred on such items is recoverable, but output VAT needs to be charged on the value of these items.

In our experience, care home businesses are not aware of this rule and the exercise to correct this can be time consuming and expensive.

Next steps

The VAT rules on land and property are highly complex and this article only touches the tip of the iceberg. We recommend that any business involved with residential development takes detailed advice in advance. Preparing a road map ahead of any development should help to better manage costs, improve profit margins and avoid painful penalties.

For more information or guidance on issues raised in this article, please contact Mark Ellis or Natalie Braier.

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Commercial property groups: the current impact of transfer pricing

When the economy is unfavourable, it's time to review your intra-group debt financing.

In the current economic climate, commercial property groups have been impacted by declining valuations and high interest rates. As a result, intra-group property financing structures with UK debt owned to an offshore company can be severely affected because of transfer pricing and thin capitalisation rules. So this means property groups should be reviewing and updating their internal debt financing arrangements.

Intra-group financing arrangements

Intra-group financing is a complex area of transfer pricing for commercial property groups. Property financing structures typically consist of bank debt, intra-group debt in the form of shareholder loans, and equity reserves.

Shareholder debt is normally an attractive option (more so than equity) to fund the acquisition or refinancing of a property. Loan interest expense can reduce the amount of tax payable on the profits generated from rental of the property, thereby increasing the investment return to shareholders.

Many countries like the UK have rules to limit the reduction of taxable income through inter-company interest expenses on loans from both offshore and domestic related parties.

Transfer pricing rules specify that a related-party debt arrangement should be priced based on, and have terms consistent with, comparable third-party debt arrangements. Among other provisions, the UK has thin capitalisation rules to assess whether the borrower has more debt than it could, or would, borrow without group support when acting in its own interests in the open market.

The impact of tax rules

Decreasing market valuations and high interest rates have put pressure on existing financing structures, especially those set up during a low interest rate and high loan-to-value environment.

Such structures are becoming difficult to support and should not simply be rolled forward on identical terms. It's important to review the terms to reflect current economic circumstances. Otherwise it may be difficult to comply with transfer pricing and thin capitalisation rules. And failure to do so may mean excessive interest deductions are disallowed in tax returns.

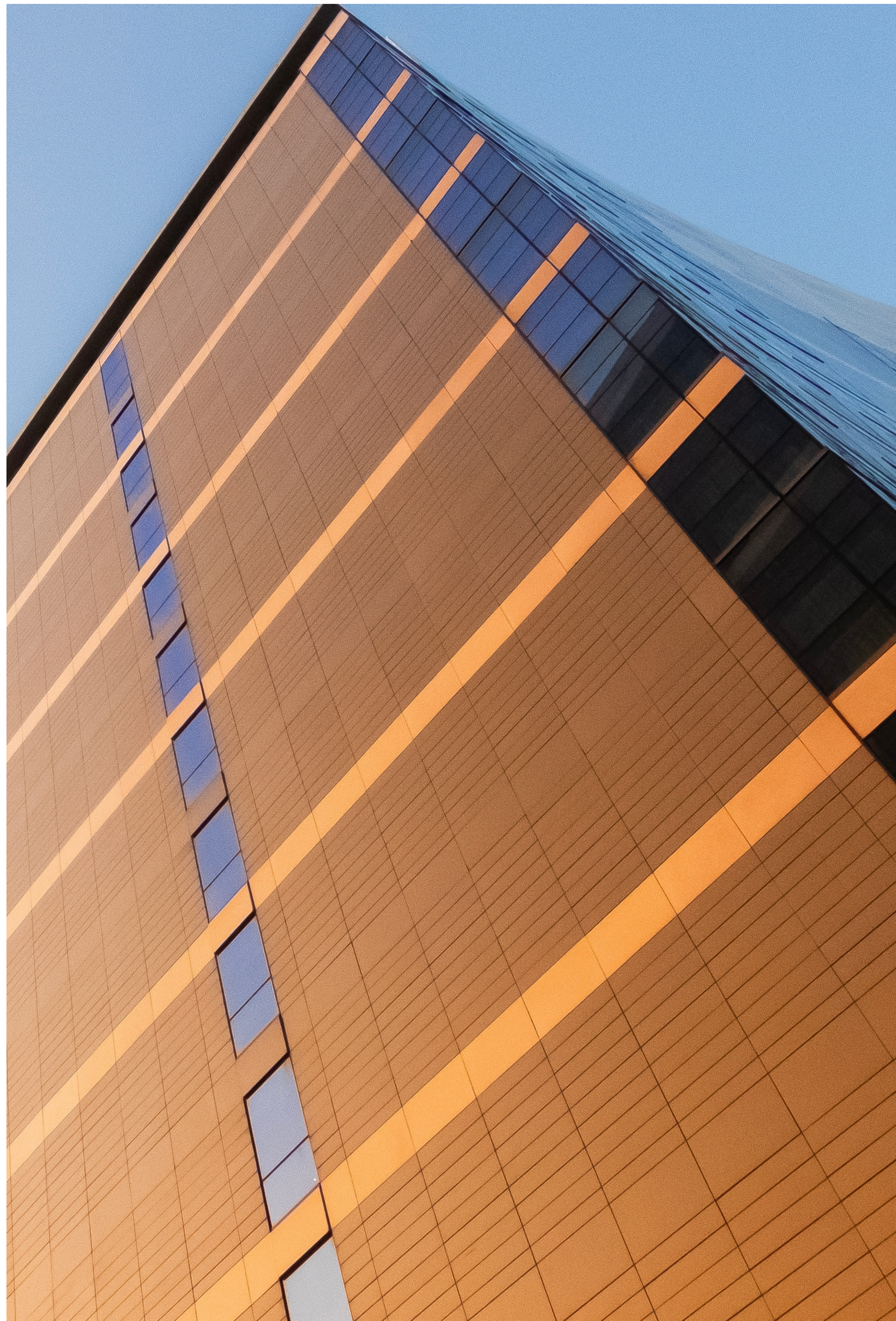
Credit metrics are useful to evaluate shareholder loans for commercial property, to assess the riskiness of a loan or general creditworthiness of the borrower.

LTV and ICR

The loan-to-value (LTV) ratio is based on the fair market value of the property and compares this to the amount of the loan. The LTV is calculated by dividing the amount of the loan by the property's market value. Borrowers with lower LTVs will usually qualify for more favourable interest rates.

The interest coverage ratio (ICR) measures a borrower's ability to service its debt from the income derived from a property. The basic calculation is EBIT divided by the total interest expenses. Lenders will generally prefer higher ICRs to be confident the borrower can service its debt.

One of the reports providing data on typical LTVs for commercial property is the Cass Commercial Real Estate Lending Survey, published by Cass Business School.



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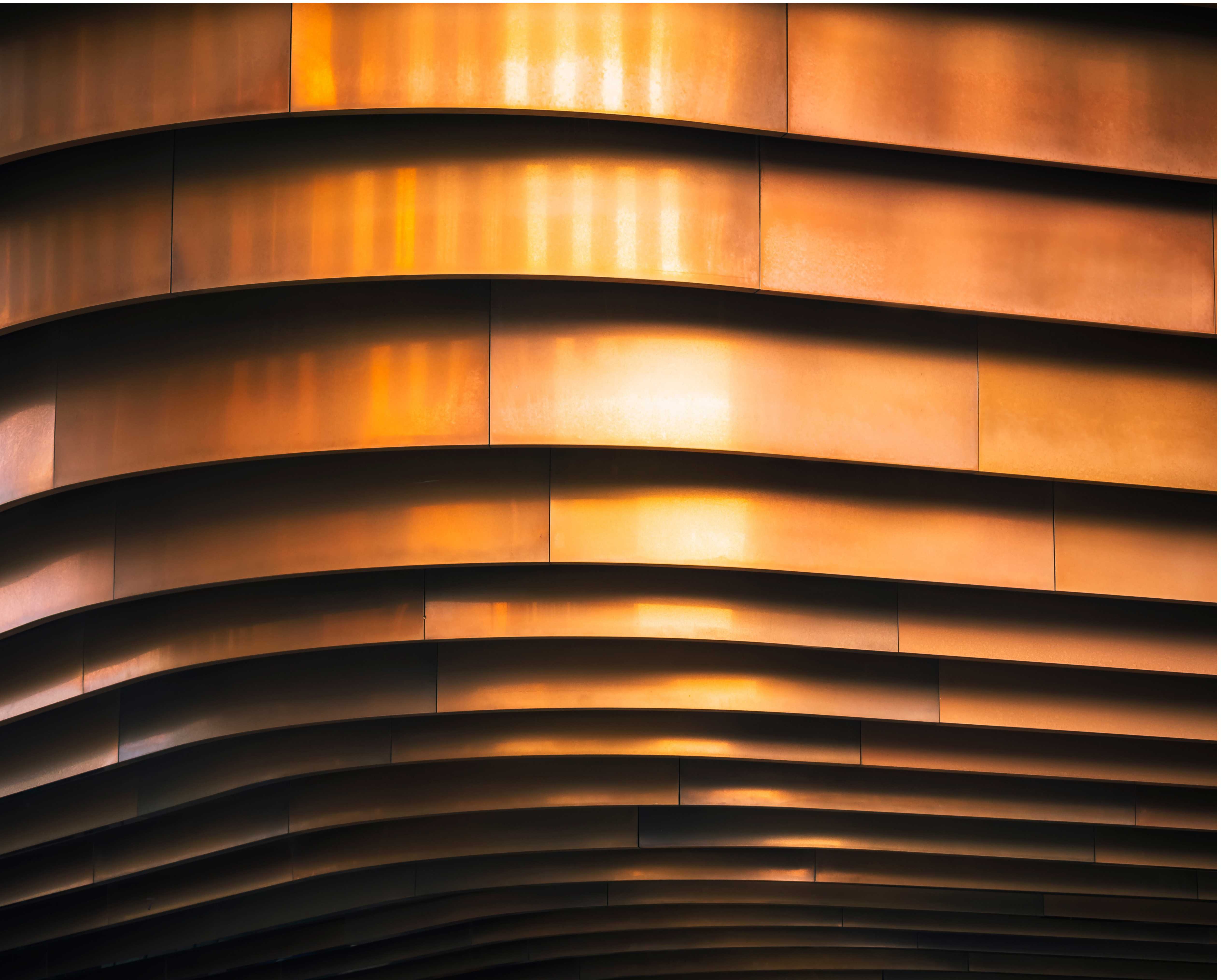

We recommend shareholder debt structures are reviewed regularly, including an assessment of key credit metrics, including the LTV and ICR. It's also worth checking the terms and conditions of clauses, such as maturity date and early repayment, to ensure arm's length behaviour between related parties. And, as third-party financing arrangements are being renegotiated, intra-group financial arrangements should be reviewed at the same time.

Next moves

Commercial property groups should regularly review whether, and to what extent, the economic environment is impacting their existing intra-group debt financing arrangements. The priorities should be to ensure:

- Robust comparability and benchmark data. Update pricing and terms of intercompany debt financing based on fresh analysis of comparable transactions, with robust economic analysis and potential adjustments
- Implementation, documentation and compliance. Thorough execution of revised inter-company debt interest expenses, maintenance of proper records and preparation of transfer pricing documentation can be crucial for demonstrating arm's length compliance.

Given current conditions, commercial property groups that review and update their intra-group financing arrangements will be more likely to avoid unwanted financial and tax compliance consequences.

For more information or guidance on issues raised in this article, please contact Farhan Azeem.

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About PKF
Simplifying complexity for our clients

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11th largest Tax practice in the UK

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Our tax services At a glance

"By bringing together the extensive expertise and experience of our tax specialists we can provide a fully rounded service that offers excellent value for money."

We offer comprehensive tax compliance and advisory services to a range of clients, both in the UK and globally, helping them find their way in the increasingly complex world of tax.

We find practical solutions that we use to our clients' advantage. Our team of experts supports individuals, and businesses ranging from start-ups and SMEs to large international groups, both listed and privately owned.

Where understanding of our clients' sector makes the difference, our experts invest their in-depth industry expertise to provide invaluable support and insights.

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We provide specialist corporate and business tax advice on both a local and international level, which includes senior accounting officer and large business compliance, transfer pricing, transaction services, due diligence, R&D tax relief, employer solutions and global mobility. We also support both the personal and business affairs of partnerships and LLPs.

Read more

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Our team will guide you through the complex world of taxes, helping you meet all filing requirements and identifying risks and opportunities to help mitigate tax liabilities.

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VAT and Indirect taxes

Our indirect tax team will support you in meeting your VAT compliance objectives and advise you on any VAT issues that your business faces.

We can ensure that your VAT risk is assessed and managed, and that your VAT recovery is optimised. We can also provide advice and compliance services on other indirect taxes, such as Insurance Premium Tax, Customs duty, and Air Passenger Duty.

Read more

Tax disputes

HMRC is increasing the number and scope of tax investigations into both individuals and businesses, covering all aspects of potential underpayments of tax, including offshore investments, personal and corporate Self Assessment Tax Returns, PAYE and NIC compliance and VAT.

If an issue arises, our trusted advisors will match the right specialists with your needs to provide you the necessary support – whether for a routine HMRC enquiry or a more complex investigation.

Read more

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