UK Real Estate Investment

Successfully navigating a changing marketplace

Contents

Mastering the three C's
Creation, construction and caretaking

Compliance and ethics

Successfully setting up and managing a real estate portfolio means successfully navigating the three C's: creation, construction, and caretaking to ensure your assets and profit are safeguarded.

Throughout this series, we'll explore the property lifecycle from creation to caretaking (including selling and exiting), sharing key insights into how to manage tax liabilities and secure a robust and profitable company in the dynamic UK market.

Contents

Part one

Getting set up and funding considerations

Whether you're a first-time or seasoned property investor, before you embark on your new project, it's worth revisiting best practices in company creation, including set-up, structures, and funding sources. With evolving tax considerations, the best structure for this venture may be different from prior experiences.

Setting up and funding considerations

Structuring your UK Real Estate investment

Mick Calam

Development or longer term?

The acquisition and management of a property portfolio (whether for development or longer-term rental and investment) can require substantial funds.

Before creating your company and deciding on its structure, you'll need to have considered your funding options; whether you're creating a property investment fund or making a collective investment

in a single UK property, establishing the right structure from the outset will ensure a commercially appropriate, tax-efficient structure is put in place, avoiding problems later.

Questions to consider when assessing your real estate funding options

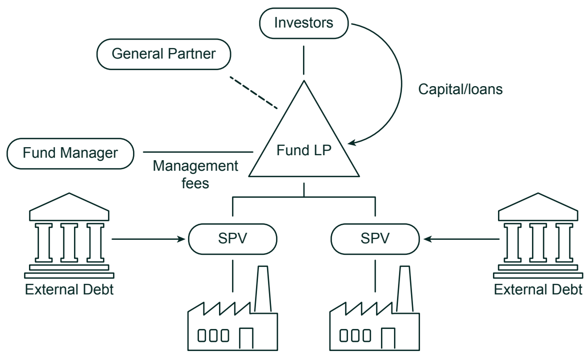
- Who are the investors?
- Where are they located?
- How much funding is required?
- What is the nature of the investment – debt or equity?
- How will returns be made?
- Where are the property managers based?

Funding through private equity real estate funds

The most common funding option for large real estate ventures is a professionally managed private equity real estate fund. For collective investment, these funds provide the means to have a dedicated pool of capital to fund new investment deals and for capital to be available without having to go through the more onerous process of launching a REIT (Real Estate Investment Trust) or another regulated fund.

Once acquired, typically, a property fund will be established as a Limited Partnership ('LP'). The LP will hold each property (or site) in a separate Limited Company, known as a Special Purpose Vehicle (SPV).

An example of how this funding structure and setup works is outlined below.



Structuring your UK Real Estate investment

Benefits

Funding real estate

Will ensure a commercially appropriate, tax-efficient structure is put in place.

Tax benefits of funding real estate through a private equity real estate fund

LPs are taxed as a partnership in the UK, and investors are subject to UK tax on their share of the LP's profits as they arise.

From a cash-flow and tax perspective, this structure provides the following benefits:

- By virtue of the general partner, the investors (also referred to as limited partners) will be limited in their liability to the extend of their investment;
- Investors can structure the holding of their interest in the fund as appropriate for their own tax and commercial requirements; The managers of the fund can charge their services to the fund (although there can be VAT considerations with respect to the structure of this)
- Performance fees or carried interest may be structured to provide incentives to fund managers to maximise returns. Returns on carried interest are, subject to detailed conditions, subject to tax at 28% on receipt by the fund manager;
- Entities can be added to ensure debt is structured and secured as appropriate for the needs of the fund and the lender(s).

Overseas investment considerations

There have been significant changes to the taxation of UK real estate in recent years. The changes mean that investors in UK real estate are subject to UK tax on profits and gains arising from UK property regardless of the investor's residency. As a result, the tax benefits of establishing a fund structure overseas are limited.

Accounts preparation and filing requirements

The legal form of the entities in your real estate portfolio and underlying agreements will drive your requirement when it comes to accounts preparation and filings.

For UK incorporated entities, unless there is an exemption under statutory law, financial statements (audited or unaudited) will be required to be filed a Companies House no later than 9 months after the accounting reference date. Financial statements will be prepared under UK GAAP or International Financing Reporting Standards. This is typically your choice, but the financial reporting framework may be specified in the Limited Partnership Agreement or by investors.

We can assist with advising you on the accounts preparation and filing requirement of the entities in your structure.

Audit requirements

Standalone UK entities

A standalone UK entity is required to have an audit if it exceeds two of the three thresholds below either in its first accounting period, or for two consecutive periods:

- Turnover of more than £10.2m (net) or £12.2m (gross
- Gross assets of more than £5.1m (net) or £6.1m More than 50 employees
- Please note that these thresholds are expected to increase in the future.

UK subsidiary of a worldwide group

It is likely that the SPVs will be part of a worldwide group. In this instance, the size of the group needs to be assessed to determine the audit requirements of the parent company and its subsidiaries.

Please refer to the following article for more information: Does my UK subsidiary need an audit? (Buzzacott.co.uk)

Setting up and funding considerations – continued

Structuring your UK Real Estate Investment

Structuring
Funding real estate
Will ensure a commercially appropriate, tax-efficient structure is put in place.

Qualifying partnerships

As discussed above, the typical structure is the incorporation of an LP where investors will pool their funds. Where a partnership is incorporated in the UK, it will be defined as a qualifying partnership if its members or, in the case of a limited partnership, its general partner is:

limited company;

a) a limited company;

b) a unlimited company each of whose members is a limited company;

c) a Scottish partnership which is not a limited partnership, each of whose members is a limited company; or

d) a Scottish partnership which is a limited partnership, each of whose general partners is a limited company.

Members are defined in Paragraph 3A of The Partnerships (Accounts) Regulations 2008.

We will be able to assist with providing you guidance on the audit and accounting requirements if your LP meets the definition of a qualifying partnership.

Part two

Establishing a property investment structure

When purchasing a property or site for development or buy-to-let purposes, it's important to consider the commercial and tax factors. Understanding commercial implications will help you to make informed decisions that can maximize return on investment, while being aware of tax implications can significantly impact the overall cost and profitability of your investment. Buzzacott can work with you to balance key tax and legal considerations against the commercial and operational objectives of your investment.

Establishing a property investment structure

Financing
your Property
Will ensure a commercially appropriate, tax-efficient structure is put in place.

Questions to consider when purchasing real estate:

- Are you looking for a development or to buy and let?
- Is the property commercial or residential?
- Are you buying property or land?
- Are you acquiring an asset or a Special Purpose
- Vehicle (SPV) – is due diligence required?
- Where will the property sit within the group – is an SPV required?
- How are you going to fund the acquisition – debt or equity?
- What is the VAT status of the transaction?

Financing your property acquisition

An SPV will often be set up for each investment or category of investment. This can help to isolate financial risk, attract investors, and provide a clear legal structure. As well as being aware of the commercial and tax implications, it is also important to consider:

- Will the SPV be solely funded by the investors, or is external funding required?
- What are costs and expected returns?
- How will you manage financial and investor risks?
- What are the financial projections? Do you have a contingency plan in place?

Managing interest expenses and corporate tax

When debt funding is used to fund the acquisition, there are several corporate tax considerations which may apply depending on the level of debt and size of the group. These include:

- Corporate interest restriction rules: does the SPV have sufficient interest allowance or should the interest be restricted? If restricted, this will create additional filing requirements with HMRC.
- Thin capitalisation: the loan must be at arm's length under the UK transfer pricing legislation. If the interest payments are excessive, they will be disallowed.
- Withholding tax: depending on the investor profile, withholding tax may be payable on the interest payments if there are individual or overseas investors. If tax is withheld, then a quarterly CT61 return is required to be filed.

Understanding property tax obligations

Once the property has been acquired, Stamp Duty Land Tax 'SDLT' will be payable by the SPV on the purchase price (including any VAT):

- Non-residential property: SDLT is paid in slices, starting at 2% on the purchase price over £150,000 and increasing to 5% where the purchase price exceeds £250,000.
- Residential property: SDLT is payable at 15% on amounts above £500,000.

Relief may be available when a residential property is acquired by a company for a property rental business or by a property developer, subject to certain conditions.

Property development and investment businesses are exempt from ATED (annual tax on enveloped dwellings) although a return must still be filed with the exemption must be claimed annually.

Managing VAT costs and cashflow

VAT is a key consideration in respect of any property purchase and development. The rules can be complex in respect of whether you will be charged VAT on the purchase of any property or land, what rate of VAT will apply to any redevelopment and construction work, and if you are entitled to reclaim the VAT incurred. It will be important to consider the following as a starting point:

- What is the intended income from the property and what is the VAT status of this income? In order to be in a position to reclaim VAT incurred on costs, you will need to make (or plan to make) a taxable supply of the land or property which will subject to VAT at 0%, the reduced rate (currently) 5%, or the standard rate (currently 20%).
- Is the property residential? If so, no VAT should be charged when purchasing the property.
- It is important to remember that professional fees associated with any purchase are likely to attract VAT even if your land or property purchase is not subject to VAT.
- Is the property commercial? If so, has an option to tax been made over the property? The sale of commercial property that is more than three years old is exempt from VAT unless an option to tax is made over the property
- Are you buying land or property that has been opted to tax? If so, is there an opportunity to disapply (cancel) the seller's option to tax? In certain cases, it is possible to disapply an option to tax.
- Should you opt to tax the land and property before development or disposal?
- Any letting of property for holiday letting, or accommodation that is similar to a hotel or inn is subject to VAT at the standard rate.
- It is important to register for VAT at the right time and be able to demonstrate the future intentions of the business in order to be able to reclaim any VAT incurred as early as possible for cashflow purposes.
- It is possible to buy an existing property that is let out as a business without paying VAT if certain conditions are met i.e. acquired as the transfer of a going concern.
- There are different rates of VAT that can apply to construction and development works to property ranging from 0% to the standard rate of VAT which is currently 20%.
- Is there an advantage to be gained by using a design and build structure for a development.

There will be additional considerations depending on the type of property and development involved and Buzzacott can provide advice specific to your circumstances.

Part three

Developing your UK real estate property

As the needs of your real estate investment evolve, it is important to maintain robust financial planning and reporting, while ensuring ongoing regulatory and tax compliance and points to consider when preparing for your audit. Our expert real estate team is ready to assist you in navigating these complexities.

Key financial considerations for real estate development

Profits
taxed as a trade
Will ensure a commercially appropriate, tax-efficient structure is put in place.

Further funding for the development

Prior to gaining any further funding required for ongoing development, you will need to ensure you've re-reviewed:

- the corporate interest restriction;
- thin capitalisation; and
- withholding taxes.

Profits taxed as a trade

The SPV must prepare and file a UK corporation tax return to comply with legal requirements, maintain financial transparency, avoid penalties, accurately report profits or losses, and ensure sound financial management.

Residential Property Developer Tax ('RPDT')

Where profits are earned by companies from the development and sale of residential property, RPDT is charged at 4% on profits arising across a group in excess of £25 million.

The computation of RPDT differs from that of corporate tax. Profits must be appropriately assessed and reported to avoid penalties.

Construction industry scheme (CIS)

CIS focuses on payments for labour made under a construction contract. Under the scheme, property developers must deduct CIS tax (20%) on the labour element of their subcontractors.

Property investment operates slightly differently. A property investor will not have to operate a CIS scheme in most cases unless they carry out significant construction work.

Failing to register could lead to penalties and can happen even when all the subcontractors are registered as self-employed and have paid their own taxes.

Research and development relief claim

For unique or complex developments, consideration should be made as to whether there is scope for an R&D relief claim.

VAT

VAT planning is essential when undertaking any development work, especially any construction or refurbishment work. This will be a key consideration not only to mitigate the cost of any such works depending on whether the VAT incurred on costs can be reclaimed or not, but also for cash-flow considerations.

Whether the VAT incurred on these costs can be reclaimed or not will depend on the VAT treatment of the income, or anticipated income associated with the property. For any such work costing more than £250,000, the VAT recovery will be potentially adjusted over a 10-year period for any change in use under the Capital

Goods Scheme (providing the costs have been capitalised for accounting purposes).

There are also various VAT reliefs that are available for certain construction services, mainly around the creation of new residential dwellings, or buildings that will be used by a charity for certain qualifying purposes (for non-business purposes and not as an office), and the conversion of buildings to residential dwellings. In addition, there are VAT reliefs available for the installation of certain energy saving materials. The application of these VAT reliefs is especially important if you are unable to reclaim the VAT incurred on costs in full.

The sale of a new (constructed less than three years ago) commercial building is compulsorily standard rated for VAT purposes, whereas the letting of a commercial building is exempt from VAT (which means that the VAT incurred on costs related to the property cannot be reclaimed) unless an option to tax is made over the building.

If an option to tax is made any sale or letting of the building becomes taxable at the standard rate of VAT (which allows for VAT recovery of VAT incurred on related costs). However, there are also specific circumstances which allow the buyer/lessee to disapply (cancel) an option to tax, which would revert the sale back to being exempt.

In certain cases, it may also be possible to structure the development work differently to mitigate any potential irrecoverable VAT costs. This can be a complex area of VAT and care must be taken to mitigate and plan for any potential VAT costs.

Audit considerations for investment properties

Under UK GAAP, the definition is:

Property (land or a building, or part of a building, or both) held by the owner or by the lessee under a finance lease to earn rentals or for capital appreciation or both, rather than for: (a) use in the production or supply of goods or services or for administrative purposes, or (b) sale in the ordinary course of business.

Under IFRS, the definition is:

Investment property is land or a building (including part of a building) or both that is:

- held to earn rentals or for capital appreciation or both;
- not owner-occupied;
- not used in production or supply of goods and services, or for administration; and
- not held for sale in the ordinary course of business.

Accounting treatment

- UK GAAP – initially measured at cost and then subsequently at fair value at the end of each reporting period.
- The changes in fair value are recognised in profit or loss.
- IFRS – you can use either the cost model or fair value model. If the fair value model is used, the same treatment as UK GAAP applies.

Valuation of properties

Under UK GAAP, your properties can be valued by a third party or by a management expert, such as the director. Under IFRS, a third-party valuation must be obtained.

It is likely you will have obtained a third-party valuation when purchasing the properties and if this is close to the financial reporting date, you may consider that is appropriate to use this to determine the value of the properties in the financial statements. If this was not obtained close to the financial reporting date, then you may wish to obtain a third-party valuation where the valuation date is the financial reporting date.

The audit team will likely request to speak to the Chartered Surveyors that carried out the valuation to gain an understanding of the assumptions that have been used such as void periods, future rental income for vacant units (in a shopping centre for example) and additional information on the methodology used.

If a directors' valuation has been prepared, the audit team will need to obtain sufficient, appropriate evidence that the director's competence and qualification to be able to accurately value the properties. If it is deemed appropriate for the director to prepare the valuation, the audit team will need to speak to the preparer, similar to when there is a third-party valuation report, to gain an understanding of the assumptions used and the methodology.

Debt structure

The fund can be financed by third-party or investor debt, as discussed in Part 1. Some of the points that the audit team will look at are as follows:

- Covenants - the audit team will review the covenants in the terms of the agreement and obtain details from you on with the terms have been met during the period and after the reporting date.
- Repayment of the loan – the presentation of the debt in the financial statements will be determined by the terms in the agreement, being the repayment date and whether the borrower or the lender can repay/recall at any time.
- Loan arrangement fees – these should be capitalised and debited against the loan and amortised over the term of the loan.

Revenue recognition

Revenue earned by the entity as lessor is recognised on a straight-line basis, unless another systematic basis is more representative.

You should ensure that the terms of the lease are reviewed in detail to ensure that any lease incentives are considered and recognised over the term of the lease.

Part four

Letting the property

Once your real estate property has been developed, you may choose to explore the option of leasing it out, which can have significant tax implications. Buzzacott can advise you on how best to structure the lease to optimise tax benefits and minimise liabilities.

VAT

Recovery

Will ensure a commercially appropriate, tax-efficient structure is put in place.

Key financial considerations when letting your property

Generating profits within the SPV

If an SPV holds an investment property, it will be in receipt of rental income, with net profits subject to corporation tax.

Profits generated can be left within the SPV and reinvested in the maintenance of the property, or distributed as dividends. In a fund structure, no withholding tax will be due on the dividends paid up from the SPV.

Construction Industry Scheme (CIS) de-registration

If the SPV stops its development trade and chooses to hold the property as an investment, they must de-register from CIS and stop filing monthly CIS reports, even if they have only stopped temporarily.

Understanding dry tax charges

If a developer chooses to let a previously developed property, a dry tax charge will arise as the property must move from being held as trading stock to an investment. The SPV will be charged on the difference between the value the property is held at in trading stock and the market value at the date of transfer, despite the fact no profits will be realised at this point.

From a commercial perspective, the fund may want any letting properties held by a different side of the group. The fund can either move the property itself into a new SPV, or the SPV itself can be transferred across.

Capital allowances

It is essential to determine whether capital allowances for landlord works are available on the property - this should be discussed and agreed as part of any work on the property. Care is needed where works are undertaken by the tenant but in part relate to landlord areas for which capital contribution has been made.

Proper tax structuring must be carried out and appropriate elections should be filed with HMRC to ensure maximum capital allowance tax relief can be claimed. If not, you risk losing the value of the capital allowances on acquisition.

VAT

The VAT liability of letting income following development being completed depends on the type of property being let as follows:

- Residential property rental – exempt from VAT (a lease of less than 21 years)
- New residential property rental – the first premium or rental payment is zero-rated (subject to certain conditions being met when a lease of over 21 years is granted for new residential property. The subsequent income from the second rental payment onwards will be exempt from VAT.
- Commercial property rental – exempt from VAT (not opted to tax)
- Commercial property rental (opted to tax) – subject to VAT at the standard rate

It is important to remember that VAT recovery of any costs incurred to generate letting income is dependent on the VAT treatment of the income. The VAT recovery considerations will extend to the development costs as well if there have been no supplies made since the development was started.

VAT incurred on costs used to generate exempt income cannot be reclaimed (subject to certain de-minimis limits) whereas there is full VAT recovery if taxable income that is subject to VAT (at the zero, reduced or standard rate). The VAT recovery position extends to the development costs as well, so it is possible to reclaim VAT incurred on a development project based on an intention to make taxable supplies

For commercial property, the default position is that the rent is exempt from VAT unless you choose to opt to tax the property and charge VAT on the rent. The option to tax must be notified to HMRC before any rental income is received and there are certain conditions that must be met.

Depending on the status of your tenant, it may also be possible for the option to tax to be disapplied in certain circumstances, it is important to note that any prospective tenant that intends to do this must notify you before you enter into any agreement for the rent, which gives you an opportunity to consider the effect on your VAT recovery position before agreeing the rental agreement.

In respect of residential property, there are special rules that apply if you intended to make a zero-rated sale of newly developed residential property, but due to external issues and market considerations the property did not sell so you chose to rent the property instead. In this situation, special calculations are required to apportion the VAT recovery between the temporary exempt rental and the intention to make a zero-rated sale of the property.

Part five

Selling your property

In the UK real estate market, selling a property can be a time-consuming and stressful process. Buzzacott can help you to craft a smart exit strategy, empowering you to make the right choices for your financial future.

Costs
your Property
Will ensure a commercially appropriate, tax-efficient structure is put in place.

Key considerations for selling your property

When you consider selling your property a key factor for consideration is that, once the property is sold, the profits generated from the disposal will be subject to corporation tax.

Some development structures can include partnerships (an LLP or LP). In these cases where the investors are individuals, whether a property is acquired for development or **investment** is important.

Where the property has been acquired for development (see section 3), the profit from the sale of the developed property will be taxed as trading profits, at income tax rates.

Whereas for an **investment** property (see section 4) income tax arises on rental profits but any gain on the property sale is subject to capital gains tax.

Once the property is sold, consideration should also be given to the most efficient manner of extracting the cash generated from the SPV to the fund before the SPV is closed down.

Closing down the SPV

Once the property has been sold, the SPV should be disbanded as a legal entity. It can be closed down via a voluntary striking off or through liquidation.

Liquidation is more costly but if there is a risk of contingent liabilities or claims, liquidation brings greater finality. For individual investors there may be a tax preference for liquidation.

Selling the SVP

The purchase price for an SPV will be determined by an agreed valuation of the property.

An adjustment may need to be made for rent collection over the course of the letting term. Any rent collected by the SPV belongs to the SPV, and not to the seller. Therefore, if the rent has not been distributed by way of dividend, the buyer will receive the benefit.

In addition, the price will need to be adjusted to reflect any outstanding liabilities in the SPV. These may include service charges, rent apportionments, insurance, and VAT recoverable.

If the SPV is sold with an unrealised corporation tax liability in relation to the unrealised gain on the sale of the property, the buyer may expect a price adjustment for this liability.

Stamp Duty

If the property is sold, Stamp Duty Land Tax (‘SDLT’) will be payable by the buyer on the purchaser price (including any VAT). The SDLT rates will be the same as outlined in section 2.

If the shares in SPV are sold, Stamp Duty will be payable at 0.5% of the purchase price.

Sale
your Property
Will ensure a commercially appropriate, tax-efficient structure is put in place.

VAT

It will be important to consider the VAT treatment of the sale and the different options available in terms of whether the property will be sold, or whether the SPV will be sold. The VAT status of the sale and whether it is taxable or not will crystallise your entitlement to VAT recovery on costs incurred including earlier development costs.

The VAT treatment generally applicable for a sale is summarised below:

Residential property

- The first freehold sale of new residential property is zero-rated
- Any subsequent sale (after the first sale of a new property is exempt from VAT)

Commercial property

- Less than 3 years old – subject to VAT at the standard rate
- More than 3 years old – exempt from VAT (not opted to tax)
- More than 3 years old (opted to tax) – subject to VAT at the standard rate
- Situation where the option to tax has been disapplied – exempt from VAT
- Disposal with tenant in situ – special Transfer of Going Concern provisions to consider

Sale of SPV

- Transfer of a going concern as part of a business sale (or property letting business) whether the business is for residential or commercial letting can qualify as being outside of the scope of VAT subject to certain conditions being met.
- Sale of shares in SPV – exempt from VAT

It is important to remember that the VAT recoverability of any costs incurred to generate the sale of the property is dependent on the VAT treatment of the income and whether it is taxable or not. In the case of a transfer of a going concern, this is not deemed to be a supply for VAT purposes and the VAT recovery will be dependent on what the business activity was before it was sold and whether this was taxable or not.

If you are reliant on an option to tax to create a taxable sale of a commercial property, depending on the status of your purchaser, the option to tax may be disapplied. It is therefore important to note that any prospective purchaser that seeks to disapply an option to tax notifies its intention to you before entering into the agreement for the sale, which gives you an opportunity to consider the effect on your VAT recovery position before finalising the sale agreement.

VAT incurred on costs used to generate exempt income cannot be reclaimed (subject to certain de-minimis limits) whereas taxable income that is subject to VAT (at the zero-rate or standard rate). The VAT recovery considerations will extend to the planning and initial costs as well if there have been no other supplies made since the development was started. There may be a claw back of any VAT reclaimed to HMRC if it was initially claimed on the expectation of making taxable supplies but that did not materialise and instead an exempt supply was made when the property/SPV was sold.

Conversely if there is initial VAT restriction based on an intended exempt supply, but instead a taxable supply is made, then a payback situation is possible resulting in a payment from HMRC

Audit

Selling the property during the accounting period

If you sell a property in the accounting period that is being audited, the audit team will review the underlying supporting documentation to ensure that the value of the property being disposed of it reflected accurately in the financial statements.

The investment property will likely have been subject to unrealised gains and losses over the period of time that it has been held by the entity and also deferred tax recognised. The unrealised gains and losses will have been recognised in retained earnings, or a separate non-distributable reserve account.

Upon disposal, realised gains or losses will be recognised in the profit or loss account and will be treated as distributable reserves.

See the previous page for the tax implications.

Selling the property after the accounting period but before issuing the financial statements

There will be a disclosure in the financial statements to state that the property or properties have been disposed of, including the sale price and the value of the property held in the financial statements.

If the sale is close to the financial year end, the audit team is likely to use the post year end sale to test the accuracy of the valuation of the property or properties held in the financial statements. If the value is materially different to expectations, the audit team will be required to investigate this further.

Impact on basis of preparation of the financial statements

If the property or properties are sold during the year or after the reporting date and it is the intention of the directors or members to wind down the SPV, the directors will need to assess whether the financial statements should be prepared on a basis other than going concern.

This is appropriate where the entity is not expected to be trading or in existence for a period of 12 months from the issuance of the financial statements.

Contact us

Our Real Estate team can provide expert advice at all stages of the property lifecycle and will work with you to identify the most effective strategies for your real estate venture. We'll also provide continuous support to ensure ongoing compliance to address the continuous needs of your property portfolio.

Phil Westerman
Partner

westermanp@buzzacott.co.uk
+44 (0)20 7556 1299

Liam McKeevor
Partner

mckeevorl@buzzacott.co.uk
+44 (0)20 7556 1244

Buzzacott

www.buzzacott.co.uk
enquiries@buzzacott.co.uk

+44 (0)20 7556 1200
Buzzacott LLP
130 Wood Street
London EC2V 6DL