

# UK RESIDENTIAL PROPERTY: DEVELOPMENT

## BACKGROUND

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A property which is purchased to be developed and sold at a profit will be treated as property development for UK tax purposes. That profit is treated as trading income. Any non-resident person who trades in the UK, which includes UK property development, will be taxed in the UK under first principles. Until recently it was possible to use an Isle of Man or Guernsey company to carry out UK property development. In certain cases the double tax agreement (DTA) between the UK and IOM / Guernsey would block the UK's right to tax the profit, meaning the profit could only be taxed (if at all) in IoM / Guernsey. This planning was blocked in March 2016. The solutions below provide ways of mitigating UK tax on development profit.

## OPTION 1: UK COMPANY

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Summary of the tax treatment of property development through a UK company

- **SDLT on acquisition:** check whether the non-residential rates apply or (if the property is pure residential), the residential rates; if the residential rates apply so will the 3% surcharge. But if multiple-dwelling relief applies (i.e. where two or more dwellings are acquired under a single transaction) the 3% surcharge should not apply.
- **CT on sale:** the gain(s) made on the sale(s) of the development property is subject to CT. The company must register for self-assessment. The company is able to deduct standard expenses including the purchase cost, development cost, labour and interest on any loans used to purchase / develop the property from the proceeds of sale(s). The profit is subject to CT.
- **ATED:** NB that a UK company may need to claim the ATED development exemption, particularly where it is a short term, small development project of an existing dwellings as opposed to a development which is a new constructions etc.
- **IHT on death:** Shares may well qualify for business property relief from IHT on the shareholder's death if the shares are held for two years or more and the company is still engaged in UK development projects on s/h's death. A non-resident individual should probably hold the shares in a UK company through an overseas holding company to provide further IHT planning (although the 2017 IHT changes affecting non domiciles investing in residential property through structures must be watched).

NB: It is possible for a UK company to reduce its taxable profit by being capitalised by shareholder loan on commercial terms. WHT on loan interest will be 20% unless the lending party resides in a treaty country, or unless the EU Interest and Royalty Directive (the Directive) is in point. Consider setting up a finance company in Hong Kong or Malta.

## EXAMPLE 1: HK / UK DTA

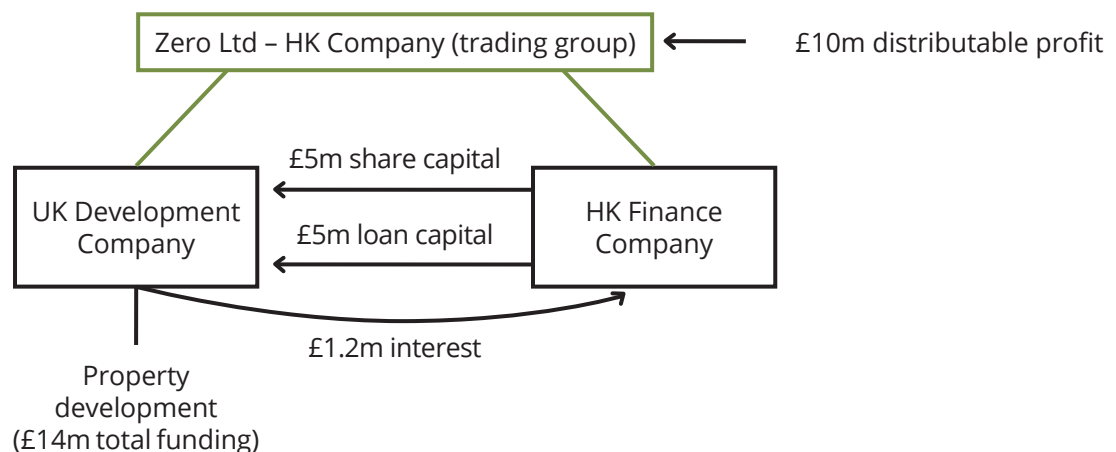
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Zero Limited is a Hong Kong holding company of a corporate group with subsidiaries registered in both offshore and onshore states. The group is comprised of trading companies (involved in TV and media) and property development and investment companies. Zero Limited has £10m of distributable profits which the board has decided to invest in UK property development projects.

- The Hong Kong company is advised to carry out the development through a UK company which will buy a brown field site on which a small block of flats will be built (planning permission for residential development has already been granted); the project will take circa three years to complete.
- Zero Limited sets up a UK company and a HK finance company. The UK company is capitalised with £5m of share capital and £5m loan (unsecured) from the Hong Kong finance company. The UK company

borrowes an additional £4m from a UK bank which holds first legal charge over the property.

- The field is acquired for £2m with an SDLT charge of £89,500; no 3% surcharge.
- The interest payable by the UK company of 8% p/a to the HK company (which is commercial and transfer pricing compliant) is a deductible expense that can be set against the UK company's income; interest is payable when the principal is repaid.
- The flats are sold to a commercial buyer for £16,000,000. The £1.2m that was paid in interest to the HK Co can be deducted from the sale proceeds, reducing the amount of CT payable. The CT saving is £228,000 (£1,200,000 taxed @ 19%). The interest paid to the HK company is not subject to UK WHT as a successful claim is made by the HK finance company. As the interest UK sourced it should not be taxed in HK.



## OPTION 2: ISLE OF MAN COMPANY

Although the benefits of using an IoM company have been limited by the amendments made to the DTA, it is still possible to use an IoM company in certain circumstances. This is likely to be where the investor is non-UK resident and is investing a sizable amount of his/her own capital to fund the development. The key part of this tax planning is that the interest paid on the loan will not be UK source but will still be a deductible against the UK profit of the IoM company making the payment. Aside from this, the tax treatment on purchase and sale is the same as that of a UK company set out above.

## EXAMPLE 2: DOUBLE IOM STRUCTURE

- Mrs Lou, a non-UK resident and non-UK domiciled, wants to invest £5m to fund a UK property development project. She is advised to set up a double IoM structure, with an IoM holding company which will hold the shares in the IoM development company. She injects the £5m into an IoM holding company as share capital.
- IoM company sets up a wholly owned subsidiary into which it transfers £5m of loan capital. The loan is commercial and on arm's length terms. The rate of interest is 9% p/a. The loan can only be enforced in the IoM; the agreement is governed by IoM law and is concluded in the IoM; interest will be payable in the IoM (although from the UK development profit). The IoM trade co is advised that the interest has a foreign source.
- The IoM company takes out a loan for £5m from a UK bank which holds first legal charge over the property.

- IoM company acquires a UK commercial property for £5m that will be converted into flats.
- Two years later the IoM company sells the property for £12.5m and repays the loan to the IoM co. The £900,000 of loan interest paid from the IoM trade co to the holding co is fully deductible from the proceeds of sale together with other deductible costs. The interest is not taxed in the UK and is not taxed in the IoM.
- Tax saving from using the IoM structure is £171,000 (£900,000 taxed @ 19%).

