Unlocking tax on rental income

International Tax | Large Corporate



01 January 2020

Caroline McCabe considers the impact of bringing non-resident companies into the charge to corporation tax on UK property rental income from 6 April 2020

Key Points

What’s the issue?

Non-UK resident companies in receipt of UK property rental income will be subject to UK corporation tax on that income and related loan relationships/derivative contracts, instead of income tax, from 6 April 2020.

What can I take away?

This change brings with it several additional complexities, requirements for extra information and new administrative tasks.

What does it mean to me?

Affected companies and their advisers should focus on the changes before the new rules come into force to ensure a smooth transition to the new regime.

The past few years have seen significant changes to the way non-resident investors in UK properties are taxed, starting with narrowly targeted provisions such as the annual tax on enveloped dwellings (ATED) in April 2013 and the introduction of a non-resident capital gains tax (NRCGT) on disposals of UK residential property in April 2015. NRCGT was replaced in April 2019, widening the scope to include disposals of UK commercial property and ‘indirect disposals’ of UK property (broadly, where interests of at least 25% in entities deriving at least 75% of their value from UK property are disposed of). The 2019 changes were fundamental and have taken up substantial amounts of advisors’ time.

With that backdrop, it is perhaps not surprising that the upcoming changes to the way corporate non-UK resident landlords (NRLs) will be taxed on their UK property business income have taken something of a back seat over the past year or so, even though they were announced before the new NRCGT rules. However, with only a few months left before the new rules take effect, it is vital that advisers and NRLs focus on this soon.

What is changing and what do the changes mean?

Corporate NRLs are currently subject to UK income tax on their UK property rental income, unless they are carrying on a trade through a UK permanent establishment. However, from 6 April 2020, they will instead be brought within the scope of UK corporation tax in respect of these profits.

There may be a difference in tax rates (the corporation tax rate is currently 19% and was expected to fall to 17% from April 2020 but this is now in doubt, compared to a 20% income tax rate). Regardless of the rates, there will definitely be some new rules to get used to under corporation tax, including additional restrictions on the deductibility of interest and restrictions on the amount of losses brought forward from earlier periods that can be offset.

Since under normal corporation tax rules, profits of a UK property business do not take into account debits or credits from loan relationships or derivative contracts, corporate NRLs will also be chargeable to corporation tax in respect of debits or credits arising from loan relationships or derivative contracts to which they are party for the purpose of the property rental business. Transitional provisions, amongst other things, ensure that there is:

- no disposal event for capital allowances purposes on the transition to corporation tax;
- no double counting of income or expenses; and
- ‘grandfathering’ of unused income tax property business losses that can be set against UK property business profits subject to corporation tax.

Interest deductibility

New corporation tax provisions restricting interest deductibility, which did not apply under income tax rules, will apply to NRLs from 6 April 2020.

Interest capping

Broadly, under income tax principles, interest is deductible against UK rental income to the extent that:

- it is wholly and exclusively related to the UK property rental business; and
- the debt is advanced on arm’s length terms.

However, from 6 April 2020, under corporation tax principles, the corporate interest restriction (CIR) will apply. These are complex rules but, broadly, they cap interest deductions to 30% of ‘tax EBITDA’ (essentially, tax-adjusted profits before interest and capital allowances). There is also a £2m de minimis (across companies in a group which are subject to UK corporation tax) and the option of using an alternative group ratio or a public infrastructure exemption (if applicable), if this will provide a

better result.

After applying the £2m *de minimis*, the deductions are also subject to the fixed ratio debt cap, which is broadly equal to the 'external' interest payable by the worldwide group. For CIR purposes, a group includes a company and any relevant subsidiaries that consolidate their financial statements together under IFRS 10 (or would do so if IFRS were applied).

In many cases, having to consider the application of these rules will increase the administrative burden for NRLs, even where there is in fact no restriction on interest deductibility. Some NRLs may even face difficulties in gathering the necessary information to determine which other entities are in the same group for CIR purposes.

Given the complexity of these rules and the reliefs available, it would be wise to review existing financing arrangements sooner rather than later.

Hybrid mismatches

UK hybrid mismatch rules have been effective from 1 January 2017 for UK corporation taxpayers and will apply to NRLs from 6 April 2020. These rules can deny interest relief completely where the NRL pays interest to a related party in certain circumstances; e.g. where, as a result of the way that different countries treat certain entities or instruments under domestic tax law, the recipient is not subject to tax on the receipt.

Losses

As a result of coming within the charge to corporation tax from 6 April 2020, corporate NRLs will be able to surrender or claim eligible corporation tax losses to/from other companies in the same group that are also subject to UK corporation tax. However, they will also be subject to the corporate loss restriction. This limits to 50% the amount of profits against which brought forward losses in excess of £5m can be offset. The £5m threshold will apply to income losses and capital losses (see below) in aggregate, and on a group-wide basis.

Existing unutilised income tax losses of an NRL will be available to carry forward and set against future UK property business profits (and relevant profits from loan relationships or derivative contracts) without restriction. However, these losses will

not be available for offset against other types of income or to be surrendered as group relief.

As noted above, since 6 April 2019, gains accruing to non-UK tax resident companies on direct and certain indirect disposals of UK property are subject to UK corporation tax. A restriction on the relief of capital losses (for corporation tax purposes) is expected to be introduced from April 2020 so that companies realising chargeable gains will only be able to use carried forward capital losses to offset up to 50% of those gains, above the £5m limit referred to above.

Determining the ‘group’

The transition to corporation tax means that the ‘group’ (if any), of which the NRL is part, must be established for various purposes. There are several different definitions of ‘group’ which may need to be considered, including for the purposes of the quarterly payment regime, the ability to group relieve losses and transfer properties between group members on a tax neutral basis, as well as various definitions of ‘group’ for the purposes of the interest capping provisions. Some of these definitions limit the group to those companies within the charge to UK corporation tax, while others do not.

Administration

Companies currently filing UK income tax NRL returns, which are not already within the charge to UK corporation tax (e.g. because they are trading through a UK permanent establishment) need to be registered for corporation tax purposes and obtain a corporation tax Unique Tax Reference (UTR). This process should happen automatically for these companies but new NRLs established on or after 6 April 2020 will need to register and notify HMRC of chargeability to UK corporation tax within three months of becoming chargeable.

Corporation tax returns will need to be completed and filed online within 12 months of the accounting period end (currently NRLs file paper returns on a tax-year basis by the 31 January following the end of the tax year). Accounts may also need to be submitted (and filed where appropriate) with the corporation tax return, another new requirement which was not necessary under income tax.

The corporation tax liability for the first accounting period will be due nine months and one day after the end of the accounting period. For subsequent periods, tax payment dates will depend on the company's taxable profits, the number of 51% group companies and the length of the period. Payments may be accelerated under the quarterly instalment payment rules, meaning that four instalment payments may be required, up to four of which may be due within the accounting period.

Where there are other companies in the group which are within the scope of UK corporation tax, it may be possible to enter into a 'group payment arrangement'. One of the companies is nominated to make the payments on behalf of all the companies within the arrangement.

As a result of coming within the charge to UK corporation tax, certain claims and elections may need to be made which were not previously required (or possible); e.g. various elections in relation to CIR, a 'disregard' election if there are derivative contracts (such as interest rate swaps) and appointing a nominated company for allocating the losses allowance and applying for simplified group relief arrangements.

Conclusion

NRLs and their advisers need to get to grips with the additional complexities that will come with the transition to corporation tax. Affected companies should review the implications of the transition to corporation tax as soon as possible, taking early action where necessary; e.g. gathering additional information required under the new rules.