Analysis

Non-resident landlords: the move to corporation tax

Speed read

With 'L-day' (as HMRC calls it) fast approaching, we should soon see the draft provisions that will bring non-resident corporate landlords within the charge to corporation tax on both income and capital gains from 2020. Although the key policy decisions appear to have already been made, *Non-resident companies chargeable to income tax and non-resident CGT: Summary of Responses* (published on 1 December 2017) showed that HMRC still had a lot of thinking to do on how the transition to corporation tax would work. This article looks ahead to what the draft legislation needs to cover.

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Non-resident landlords are definitely in the UK tax policy spotlight. In March 2017, the government set out proposals to bring non-resident corporate landlords into the charge to corporation tax (CT) in respect of their UK property business (see *Non-resident companies chargeable to income tax and non-resident CGT*, published 20 March 2017).

The main focus of the consultation was on the tax treatment of income. It particularly focused on how to ensure non-resident landlords became subject both to the new interest restrictions (which, in effect, limit tax deductions for interest to a percentage of (taxable) profits); and loss reforms (which, in broad terms, cap the use of carry forward losses to 50% of profits only). It also included proposals to tax residential property gains of non-resident companies under CT rather than (as now) non-resident CGT (NRCGT).

Then, in the Autumn Budget, the government announced that, from April 2019, all non-residents would become liable to CGT on disposals of UK real estate: a fundamental shift in how CGT works. A week later, confirmation came that, in relation to income, in the summary of responses (published 1 December 2017), the policy decisions trailed in the March consultation would be implemented. What the government had said it was thinking of doing will be done.

Non-resident corporate landlords are therefore preparing to bid farewell to the familiar (income tax and no CGT) and welcome a brave new world of CT on both income and gains. For the government, moving non-resident companies carrying on a UK property business into CT wholesale is by far the simplest way of meeting its objective of applying interest restrictions and CT loss reforms to such companies. (The alternative – attempting to rewrite the corporate interest restriction and loss rules to 'fit' within income tax – was always unlikely: though 29% of respondents to the March consultation saw this as the better option.)

However, in one area, the consultation process did seem to make a difference – and that is on the timing of the switch to CT. With restrictions on interest and loss carry forward in force from April 2017, respondents to the consultation feared that the switch to CT could be as early as 2018, and so argued strongly for a start date of April 2019. The government listened – and has gone one tax year better. The cross-over to CT for non-resident corporate landlords will now not happen until 5 April 2020 – one year after they become subject to CGT on *all* property gains.

This means government and non-resident landlords have more time to work through the detail of how to transition from income tax to CT. Corporation tax may be based on income tax principles, but developments since the early 1990s mean that there are now significant differences (particularly in relation to financing arrangements). Transitioning will not be straightforward.

In the summary of responses, the government simply says: 'There will be a need for transitional provisions to help manage the change'; and promises a further (technical) consultation with draft legislation in summer 2018. But it is clear from the summary of responses that respondents to the consultation wanted something more than this: the how, rather than the why. This article considers what we know to date about some of the issues around transition: the known knowns (i.e. where the government has given some indication of its thinking); and also the known unknowns (i.e. where the government is still thinking).

The known knowns

Compliance: getting ready for CT

From 2020, non-resident landlords – including those already known to HMRC through registration under the non-resident landlord scheme (NRLS) – will need to register anew with HMRC for CT.

In the summary of responses, the government says it 'will ensure that affected customers are informed of the changes to their customer records such as its new CT taxpayer reference'. In practice, however, non-residents are probably better off assuming they need to 'do it themselves'.

In any event, non-residents will need to re-file details of their tax agents if those agents are to continue acting on their behalf for CT: no automatic carry-over of income tax authorisation is envisaged.

Transition: periods of assessment

The 'switch' to CT will be on 6 April 2020, immediately following the end of (income) tax year 2019/20.

The summary of responses confirms that transition will involve the non-resident's (income tax) property business ending on 5 April 2020 (so a final income tax return is needed for 2019/20), and a 'new' (CT) business (and CT accounting period) being deemed to commence on 6 April 2020.

In practice, as many non-resident corporate landlords have a financial year end of either 31 March or 31 December, the change in regime is likely to lead to overlap between 'real' and deemed tax basis periods. This means two separate time-apportionments of income and expenses will be needed in 2019/20: the first to determine income tax profits (under ITTOIA 2005 s 275), and the second to allocate amounts to the (deemed) first CT accounting period starting on 6 April 2020. One respondent suggested applying the CT rules from 31 March as an alternative (so, for some non-residents, no apportionment would be needed). The government was not persuaded.

For one category of non-resident corporate landlord – those investing through a partnership – additional issues arise. Specific provisions will, therefore, be introduced to deal with the allocation of partnership income on transition to avoid double taxation of profits (or equally profits falling out of account).

Transition: a cessation, but not a real one

Deeming the (income tax) business to cease is a neat solution, but risks landlords facing unexpected tax costs under specific cessation tax rules – even though the 'actual' business not only continues, but continues to be subject to UK tax. The government, therefore, says it will mitigate these potential costs.

Capital allowances

Cessation ordinarily triggers a disposal event for capital allowance purposes, with a market value disposal value needing to be brought into account (CAA 2001 ss 61(1)(f) and 61(2) item 7).

In the March 2017 consultation, the government said it did not want the shift to CT to result in balancing adjustments, but that it was still thinking about how to achieve this. The summary of responses provides no further detail.

However, in looking at how to achieve a tax neutral transfer of tax written-down values into a 'new' CT property business, perhaps CAA 2001 s 66B (which deals with companies becoming liable to the (reduced) Northern Ireland CT rate) offers a suitable precedent.

(Income tax) losses

On cessation of a property business, unused (income tax) property losses expire, given that they can only be carried forward against property business profits (ITA 2007 s 118).

Even though the switch to CT is in part motivated by ensuring that non-resident landlords are subject to the new loss restrictions, denying non-residents relief for (past) losses simply because of a change in tax regime is a restriction too far or, as the government puts it: 'On the assumption that the income tax loss is a commercial loss, the government considers that it would be reasonable to carry forward this loss from the income tax regime into the CT regime.'

This does not mean that pre-April 2020 losses carry over as CT losses. Rather, the intention is that pre-5 April 2020 property business losses are preserved as a new category of income tax loss: 'income tax property losses' (ITPLs). One advantage of this is that there will be no need to recast any such losses into their CT equivalent elements (i.e. 'pure' property losses, management expenses and non-trading deficits). Unsurprisingly, this was welcomed by all respondents.

Mirroring the treatment of (income tax) property losses, ITPLs will only be available to offset post-April 2020 property business profits (so, as now, they cannot offset capital gains or be group relieved). Plus, if the new CT property business ends, ITPLs expire.

Offset against property profits will be automatic. No claim is needed (and equally they cannot be disclaimed). ITPLs are, therefore, intended to take priority over post-April 2020 CT losses.

Preservation of past losses as ITPLs means that they do not benefit from the flexibilities afforded by the CT loss reforms. However, as a corollary, the government has confirmed that ITPLs will not be subject to the 50% CT loss cap. It is not yet clear if ITPLs will be completely outside the loss reforms, or whether they will count towards the £5m deductions allowance (which enables a group to use carry forward losses to offset up to £5m of profits without restriction).

With post-2020 CT losses/non-trading deficits of non-resident corporate landlords in the new CT loss rules, ITPLs and CT losses/non-trading deficits will need to be tracked separately. The government's view is that this 'will not be burdensome'. Tax directors may think differently however.

To show how this might work in practice, the summary of responses contains a simple case study. This is useful – but, unfortunately, reality is unlikely to be as simple, particularly if the non-resident is part of a group.

Management expenses post-2020

As outlined in the March 2017 consultation, CT relief for management expenses will be available to non-resident corporate landlords. However, if the non-resident carries on other activities (for example, it owns non-UK properties or subsidiaries), relief will only be given for expenses directly linked to its UK property business.

Financing costs post-2020

Financing costs is where non-resident landlords will notice most change post-April 2020.

Currently, non-resident landlords get relief for interest as an expense in working out income tax profits. The only limits on deductibility are the 'wholly and exclusively' condition and transfer pricing rules.

From April 2020, the position will be very different. First, financing costs will no longer be deductible as property business expenses. Instead, non-residents will have to familiarise themselves with the detail of the loan relationship and derivative contract regimes, and adjust to a world where both income and capital items are brought into account.

Secondly, from 2020, relief (for non-trading deficits) against property profits will have to be claimed.

Thirdly, the new (for them) legislative landscape means they need to consider a raft of provisions that could limit deductibility of financing costs. The connected company and unallowable purpose tests need to be considered. In some cases, the hybrid rules may apply. And, although not directly discussed in the consultation, the distribution rules will be relevant to payments made by a (CT-paying) non-resident (hence, one respondent asked that long-term loans be grandfathered as far as the distribution rules were concerned).

Given the rationale behind the move to CT, non-resident corporate landlords will need to navigate the new corporate interest restrictions, which (broadly speaking) limit tax relief for finance costs to a percentage of taxable profits (potentially as low as 30%).

Non-resident corporate landlords, therefore, face a much heavier compliance burden under CT. Some (particularly those with high leverage and/or significant shareholder debt) may find that some of their finance costs are no longer deductible.

As far as the corporate interest restrictions are concerned, the guaranteed £2m interest capacity (the de minimis) may help some avoid restriction. This is not a panacea for all, though. After all, the £2m is a group (not a company) attribute, and, in any event, assuming interest at 3%, would only cover annual interest on a loan under £67m.

The public infrastructure exception may also seem an attractive option to some, although it is only available if certain conditions are met (and even then not all debt falls within its scope).

Here, changes made to the interest restriction rules in Finance Act 2018 may be helpful. One of the conditions requires the non-resident to be 'fully taxed in the UK' (TIOPA 2010 s 433(11)). As originally enacted, this condition applied to all activities of the relevant company – and very few companies would be as fully single purpose as this required. But, as a result of FA 2018 Sch 8 para 7, this condition now references 'sources of income' only, with a new TIOPA 2010 s 433(12) meaning that 'insignificant' sources of income can be disregarded.

Swap costs and the disregard regulations

Non-resident landlords that have entered into swaps to hedge their financing arrangements also have to consider the derivative contract rules – and for some, this includes the impact of fair value accounting.

The income tax treatment of swaps is still based on general principles, contrasting with the position under CT where there have been specific statutory rules since 1994. Limited guidance in HMRC's *Property Income Manual*. PIM2015 states that, where a landlord uses a swap to hedge its obligations under a loan, then provided payments under the loan are deductible, 'profits or losses on that [swap] will be taxed or relieved as receipts or deductions of that rental business'. It adds that this should generally be done on an accruals basis. From this, it could be inferred that this is directed at periodic 'income' linked payments only (and not changes in the swap's fair value), but the position is unclear.

In any event, as non-resident corporate landlords compute property business profits using GAAP, some non-residents may have been recognising fair value movements on swaps for income tax purposes already. (GAAP generally requires such fair value movements to be taken to the income statement.) They may want to continue to do so post-2020.

On the other hand, for those non-residents who have not yet had to recognise such fair value movements, the move to a GAAP-based tax regime could be very unwelcome.

In March 2017, the government simply said that the Disregard Regulations (SI 2004/3256) would apply to non-resident corporate landlords. However, as a result of comments received during the consultation process, the government is now saying that it 'is reviewing the application of the disregard regulations so that in certain situations the existing treatment of fair value movements can be maintained'. This indicates a potential modification to the Disregard Regulations' 'all or nothing' approach.

For non-residents that do want to disregard fair value movements, there are questions around how (and when) to elect into the Disregard Regulations. Existing time limits for elections to disregard fair value movements under reg 6A could mean elections only apply prospectively (i.e. to future derivatives). This too needs further consideration.

Perhaps, unsurprisingly, some respondents simply asked for grandfathering of all pre-2020 swaps. This seems unlikely. Instead, expect some rather technical amendments to the Disregard Regulations to achieve (in practice) a similar outcome.

Non-residents and CGT

The March 2017 consultation extended beyond income tax, with the government saying that non-resident companies within the scope of NRCGT would also switch to liability under CT on relevant capital gains. The announcement at the Autumn Budget that, from April 2019, all disposals of UK real estate would be within the charge to CGT means that, post April 2020, CT will apply to all non-resident corporate landlords with UK real estate, whether residential or commercial (though the CGT reforms mean that non-resident corporate landlord will be subject to UK tax on disposals made in tax year 2019/2020, albeit under CGT and not CT).

It seems, however, that a distinction between residential and other property will be maintained in part. The summary of responses reaffirms that NRCGT computation rules will continue to apply to relevant gains after 2020 (albeit this is stated to be subject to the outcome of the broader CGT consultation). This should maintain a relatively level playing field as between corporate and non-corporate owners of residential property in working out the quantum of any gain. But when it comes to accounting for tax, however, being a company may have a benefit. The summary of responses suggests that, from 2020, companies will no longer file specific NRCGT returns (i.e. within 30 days of sale), but will instead report gains under normal self-assessment timelines. (Plus, companies are currently outside the government's proposals for a 30-day payment on account window for CGT on residential property disposals.)

Otherwise, the government says very little on NRCGT. For example, it is unclear whether any of the exemptions from NRCGT in TCGA 1992 s 14F will be preserved post-2020. This, of course, may depend on the outcome of the broader CGT consultation.

One positive in this area is that the government has agreed to revisit the treatment of ATED related gains. There was consensus among respondents that the rules were too complex. A review does not guarantee change, but at least is a step in the right direction.

The known unknowns

The summary of responses shows that compliance practicalities were a concern of many respondents. As yet, the practical side of the switch to CT is very much a known unknown.

The NRL scheme and CT: compatibility?

The NRL scheme is an income tax scheme, deriving from ITA 2007 s 971.

Post-April 2020, NRLS may still serve a useful purpose: after all, the 'stick' of receiving rent subject to withholding is effective in encouraging good compliance behaviour. However, the reporting and accounting obligations imposed under NRLS do not sit easily with the CT self-assessment regime.

Plus, should agents ever have to account for tax on the landlord's behalf, they will clearly struggle to work out with any accuracy 'net' profits under CT rules. This does question whether the current scheme makes much sense within a CT environment.

Tax returns and accounts

At the moment, nothing is known about what accounts non-residents will need to file with their CT returns, and whether those accounts will need iXBRL tags. Plus, there is no information as yet on how income tax and CT installment payment regimes will interact when the rules first take effect.

Next steps

With April 2020 just over two years away, affected non-residents should now start to consider how the move to CT will impact them. The learning curve has the potential to be very steep and the clock is ticking. Consideration also needs to be given to the systems that need to be in place to address compliance, including ensuring that their agents can still act for them post-April 2020. And, as importantly, once the draft legislation has been published in July, they, with their advisers, need to be prepared to input to try to ensure transition works as sensibly as policy decisions allow. ■

For related reading visit www.taxjournal.com

- ▶ Corporation tax and non-resident companies: a consultation (Philip Spencer & Robin Hutton, 27.4.17)
- ▶ Non-UK resident landlords to be taxed on UK property gains (Elliot Weston, 10.1.18)