US investors are a key source of investment in UK commercial property. In addition to navigating the UK tax rules applicable to an investment, those advising on transactions in which US investors are involved need to be sensitive to the often highly complex rules to which US investors, even those nominally described as ‘tax exempt’, are subject at home. In many respects, the UK tax regime applicable to investment in commercial real estate in the UK is comparatively benign. In general, provided the investor is neither resident in the UK, nor carries on a trade in the UK to which the property is attributable, UK tax will not be chargeable on capital gains arising on exit, irrespective of the jurisdiction in which the investor or any non-UK resident holding vehicle established by the investor is resident for tax purposes. Although rental income remains taxable, most expenses of a revenue nature are deductible in computing the profit that is subject to tax, with financing expenses being treated under the general income tax rules applicable to UK property businesses and not under the more complex and restrictive ‘loan relationships code’ (TTTOIA 2005 Part 3 and CTA 2009 Part 5). While SDLT can represent a significant transaction cost, many larger investment properties are held in non-UK incorporated companies or offshore property unit trusts (PUTs), the interests in which can be transferred free of UK stamp taxes (see the box on the next page for a recap of the rules for non-UK companies and PUTs).

But an analysis of the UK tax regime is only part of the picture. A US investor will likely be subject to highly complex US tax rules, and these need to be navigated as well.

What are the tax drivers for a US investor?
It goes without saying that every potential investor will have its own specific concerns and preferences, and the relative importance of issues that might be expected to apply to investors who generally share the same tax status will vary according to their particular circumstances. Investors that are themselves funds in which US investors participate may result in additional complexities, depending on what obligations the fund or its managers owe the fund’s investors in relation to tax structuring, and how the conflicting objectives of different investor constituencies are to be balanced. It is therefore important that potential investors and their US tax advisers are engaged in the structuring process at as early a stage as is appropriate. The following provides some general guidance to assist in the structuring process.

A key distinction is between investors that are taxable in the US and those that, although generally tax exempt, are nevertheless subject to tax on ‘unrelated business taxable income’ or UBTI (discussed in more detail below). REITs, although generally not subject to tax on income and gains derived from real estate investments, to the extent they satisfy certain requirements as to distribution of earnings, tend to align with taxable investors in terms of their structural preferences. Which of these categories a given investor falls into will likely determine whether that investor will prefer an entity structure that is transparent (so that profits on the underlying investment are treated as arising to the investor directly) or opaque (so that the investor is taxed as a holder of interests in the holding vehicle).

An analysis of the UK tax regime is only part of the picture. A US investor will likely be subject to highly complex US tax rules, and these need to be navigated as well.

Before looking at these preferences in more detail, one of the key points to note here is that, quite unlike most other tax regimes, for US federal income tax purposes it is often possible to elect whether any given holding vehicle will be treated as transparent or opaque. This gives rise to a greater degree of flexibility in structuring to accommodate different investor tax requirements than may be the case for UK investors, for example, in relation to whom the treatment of a holding vehicle as

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Non-Uk companies and property unit trusts: a recap

Many UK investment properties are held in companies incorporated outside the UK or in property unit trusts (PUTs).

Non-Uk incorporated companies are the more straightforward vehicle. Provided the register of members is held offshore and on the basis that shares in the company are not ‘paired’ with shares of a UK incorporated company, the shares are not ‘chargeable securities’ and no liability to SDRT arises on an agreement to transfer shares in the company (FA 1986 s 99(4)). Stamp duty is unlikely to become payable, subject to Stamp Act 1891 s 14(4). Provided the company’s place of central management and control is outside the UK and the property is held as an investment, no UK tax will be chargeable on capital gains arising on a sale of the property, subject to the anti-avoidance rules in CTA 2009 Part 18, and income tax will be chargeable on the company on the profits of its UK property business.

PUTs are more complex, being opaque for some tax purposes and transparent for others. Most often formed as trusts under the laws of Jersey or Guernsey (hence the common terms ‘GPUT’ and ‘JPUT’), care is taken to ensure that they constitute ‘collective investment schemes’ within the Financial Services and Markets Act (FSMA) 2000 s 235 and therefore as ‘unit trust schemes’ within FSMA 2000 s 237(1). Failing within this definition of ‘unit trust scheme’ has several consequences. First, transfers of units are not subject to SDLT, because FA 2003 s 101 treats the units as shares for SDLT purposes. Second, transfers of units are specifically exempted from stamp duty by FA 1999 Sch 19 para 1. Third, the unit trust is treated as a company for chargeable gains purposes under TCGA 1992 s 99. Provided the units do not constitute ‘chargeable securities’, the tax is treated as a company for chargeable gains purposes under TCGA 1992 s 99. Provided the units do not constitute ‘chargeable securities’, the burdensome (and soon to be abolished) SDRT rules in FA 1999 Sch19 Part II do not apply.

For the purposes of stamp taxes and chargeable gains, PUTs are therefore opaque. For income tax purposes, though, trust deeds are normally written so that they are transparent, following the principle in Baker v Archer-Shee (1927) 11 TC 749. Although this transparency for UK income tax purposes can be advantageous in removing an additional layer of taxation from a structure, and in particular allowing UK tax exempt investors to rely on their tax exemption in relation to the rental income, a US investor may view registering with HMRC under the non-resident landlord scheme as insulating the investor from UK tax obligations in relation to rental income.

Entity characterisation and check-the-box elections

Readers will be familiar with the general UK principles applicable to the characterisation of a non-Uk entity for UK tax purposes, in particular Memec PLC v IRC (1998) STC 754 and HMRC’s guidance in its International Manual at INTM180000. The wide use of offshore unit trusts as property holding vehicles also makes trust tax cases relevant, in particular Baker v Archer-Shee (1927) 11 TC 749, as well as the statutory rules on the chargeable gains and stamp duty land tax treatment of unit trusts at TCGA 1992 s 99 and FA 2003 s 101.

The basic approach of the UK is to identify the legal form of an entity deriving its status under foreign law, and then to attempt to characterise it for UK tax purposes by analogy and comparison with entities deriving their status under the law of a part of the UK. Although this approach can give rise to uncertainty, as illustrated by the progress of HMRC v Arison (2013) STC 557 through the courts, it means that in principle there is no choice as to how a foreign entity will be characterised.

Although the US applies a broadly similar approach to the characterisation of a foreign entity in the first instance, analysing its characteristics under its law of incorporation or formation, it is generally possible to elect the treatment of the entity as either transparent (‘disregarded entity’ or ‘partnership’) or opaque for US federal income tax purposes. Although this treatment is not available for entities akin to US publicly listed corporations, such as PLCs in the UK, it is generally available for private companies and for offshore property unit trusts treated as business entities for US income tax purposes.

The ability to choose transparency or opacity means that, in general, most US investors can be accommodated within the types of vehicle typically seen as holding vehicles for UK commercial property. transparent or opaque will be dictated by that vehicle’s legal status (e.g. company, partnership, trust). It also means that it is normally possible to insulate US investors from UK taxes yet, where desired, allow the investor to be taxed in the US on a ‘flow-through’ basis, as if it held the underlying asset directly. See the boxed-out section (opposite) on entity characterisation and check-the-box elections.

US taxable investors, including REITs

Given that US federal income tax rates are generally higher than both UK corporation tax rates and the basic rate of UK income tax applicable to rental income under the non-resident landlord scheme, it might be thought that it would be most efficient for a US investor to hold a UK property directly. However, this structure would result in the US investor, who may not otherwise be subject to UK taxes, having to register with HMRC under the non-resident landlord scheme in order for rental income to be paid to it gross (Taxation of Income from Land (Non-residents) Regulations, SI 1995/2902), file UK income tax returns and pay any UK income tax due.

Further, if the property is already held in a company or PUT, the investor may stand at a commercial disadvantage as to the price it is able to offer if it is only willing to buy the property itself, as it would then need to factor SDLT into its transaction costs whereas a purchaser who was willing to purchase interests in the company or PUT would not normally need to fund a SDLT liability and might therefore be expected to be able to offer a higher price to the seller. Similar considerations would apply on exit, with the property likely to be relatively less attractive to purchasers if exit can only be achieved by a sale of the property itself, attracting SDLT.

It follows that, from a UK tax perspective, it will normally be preferable for the investor to acquire, hold and dispose of shares in a company or units in a PUT, where the company or the PUT holds the property. If the property is in a PUT, the investor may wish to hold its units in the PUT through a company, in order to insulate the investor from UK income tax obligations in relation to rental income, treated as arising to the unitholder directly under the principle in Baker v Archer-Shee.

In contrast, from a US federal income tax perspective, holding the property directly or through pass-through entities may be attractive compared with holding it through an entity which is viewed as opaque for federal income tax purposes in light of the following factors:

- a US investor may prefer to be taxed on income from the underlying asset on a flow-through basis, as compared with the consequences of being taxed under the US’s controlled foreign corporation (CFC) or passive foreign investment corporation (PFIC) tax regimes, which could apply to investment in a tax opaque entity.
for REITs, ensuring that they are seen as receiving ‘good’ rental income for the purposes of the REIT rules; and

in the context of an acquisition of interests in an entity which holds a real estate asset, to obtain a step-up in the US tax basis of the underlying real estate asset. This final factor is also relevant to REITs, as a step-up facilitates the minimisation of a REIT’s income for US tax purposes, which in turn minimises the amounts that it is required to distribute.

Fortunately, these apparently conflicting UK and US preferences can be reconciled if the investor holds the property through a company that elects to be treated as a pass-through entity for US federal income tax purposes, although the US investor’s ability to credit its share of taxes paid by any such UK entity against its US tax liability will need to be analysed.

A PUT may also be used, although the UK income tax transparency of the PUT may mean that a US investor would wish to hold its interest in the PUT through a company, in order that the investor itself is insulated from UK income tax obligations in relation to rental income which would otherwise arise if it held its interest in the PUT directly. A US taxable investor may also wish to cause the PUT to elect affirmatively to be classified as a transparent entity, in order to confirm such treatment for US federal income tax purposes.

US tax-exempt investors

Despite their tax exemption, many US tax-exempt investors are nonetheless subject to tax on what is referred to as ‘unrelated business taxable income’ (UBTI). UBTI very generally includes income from a trade or business unrelated to the tax-exempt investor’s exempt purpose, as well as income and gains attributable to investment property, subject to acquisition indebtedness (often referred to as debt-financed UBTI). Certain passive investment income, such as interest, dividends and gains from the sale of stock held for investment, is expressly excluded from UBTI, assuming that the investment itself is not debt-financed.

UBTI-sensitive US tax-exempt investors will therefore often wish to employ a structure that will minimise or eliminate their exposure to UBTI. This will typically mean that the investor will prefer to invest through a vehicle that is regarded as opaque for US federal tax purposes, with any indebtedness incurred at or below the level of the vehicle, so that the investor is insulated from UBTI arising at the level of the vehicle (a UBTI blocker). As previously noted, because entities can generally elect their US federal income tax classification, causing an entity to function as a UBTI blocker can generally be achieved by filing a check-the-box election, where the entity may otherwise be treated as transparent for US federal income tax purposes.

Thus, US tax-exempt investors can generally expect to achieve (or confirm) the intended US tax treatment of an entity, regardless of whether it is structured as a company, a PUT or a partnership under non-US law.

US taxable and tax-exempt investors in the same structure

It will be seen from the above that the structural preferences of US taxable investors (including REITs) may conflict with the structural preferences of US tax-exempt investors.

Accommodating both categories of investor on the same investment may be possible, however, if the asset is held in a vehicle that is regarded as transparent for US federal tax purposes and into which US taxable investors (including REITs) invest. US tax-exempt investors could then invest indirectly through a further vehicle that is regarded as opaque for US federal tax purposes.

For instance, a typical fund structure would be for the main fund vehicle to be established as a limited partnership in the UK or other non-US jurisdiction (the fund LP). The fund LP would typically be regarded as transparent for US federal tax purposes and would hold individual real estate investments through holding vehicles that are also, or elect to be, treated as transparent for US federal tax purposes. US taxable investors would hold interests directly in the fund LP, and report earnings from the fund LP and its subsidiaries on a pass-through basis. A further limited partnership (the feeder LP) could be established to hold interests in the fund LP on behalf of US tax-exempt investors, with US tax-exempt investors holding interests in the feeder LP. The feeder LP would elect to be treated as opaque for US federal tax purposes and thereby function as a UBTI blocker, insulating US tax-exempt investors from UBTI from the fund LP’s investments.

Conclusion

US investors will normally bring with them specific preferences as regards the structuring of any given investment. In general, it is normally possible to accommodate these preferences within the range of structures normally seen for holding UK real estate investments. However, doing so requires the likely US tax profile of investors as well as any specific issues to be identified, and it will be most efficient if this is done at an early stage as possible.