EU Referendum

Brexit – tax implications for real estate

July 2016
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Introduction

On 23 June 2016, the British people voted in favor of the United Kingdom (UK) leaving the European Union (EU). As we have seen over the past few weeks, this decision has created significant uncertainty about what the future holds, and this uncertainty has resulted in as significant market volatility in the UK and abroad. As the following examples illustrate, the UK real estate market has certainly felt its fair share of this volatility:

- The value of a pound sterling dropped to US$1.28 on July 7, 2016, a 31-year low against the US dollar.\(^1\)
- Standard Life Investments suspended trading in its UK property fund. Standard Life Investments UK Real Estate, due to a rapid increase in redemption requests following the exit vote. Aviva, M&G, Columbia Threadneedle Investments and Canada Life, each of which sponsor open-ended real estate funds, also suspended trading in such funds.\(^2\)
- Between 23 June 2016 and 5 July 2016, the FTSE 350 real estate investment trust index fell 18.73%.\(^3\)
- A number of property funds have had their value cut including Legal & General, Henderson Global Investors, Prudential and Aberdeen Asset Management.\(^4\)
- The share prices of the largest UK home builders has dropped more than 30% since the Brexit vote.\(^5\)

Associated with this uncertainty and market volatility are potential short-, medium- and long-term tax consequences for the owners, operators and/or investors in UK real estate. In the short term, the UK will remain a member of the EU and, therefore, the referendum itself will not cause any immediate change to the UK tax environment. Looking forward, the possibility remains that the UK may implement tax and other changes as interim measures prior to a formal exit.

There are several possible paths for exit to be effectuated. For example, the UK could unilaterally repeal the European Communities Act 1972. Alternatively, an exit could be achieved through negotiations occurring pursuant to Article 50 of the Lisbon Treaty. Although it may result in a quick exit, the former seems less likely given it may create greater legal and political uncertainty. Conversely, the latter seems more likely and would seemingly be achieved through a more deliberate process during which the UK would be bound by its existing European obligations. The exact timing of many consequences of exiting will be based on the date of formal exit, so real estate owners, operators and investors should monitor the exit negotiations closely.

UK real estate owners, operators and investors should assess their strategic, business and operational models in light of the referendum result. In doing so, they should identify key tax considerations to be covered in any new agreements to enable the continued growth of the real estate industry in the UK and the EU.

The balance of this note highlights some immediate and longer-term tax considerations that may be relevant to real estate owners, operators and investors as the process toward a formal exit evolves and the framework for the UK’s new relationship with the EU become clear.

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1 As reported by the BBC. See bbc.com/news/business-36721016
3 As reported by Investing.com. See uk.investing.com/indices/ftse-350-reits-historical-data.
4 As reported by PERE.com and the BBC. See perenews.com/News_And_Analysis/2016/July/News/Standard_Life_suspends_trading_for_-£2_9bn_RE_fund_following_run and bbc.com/news/business-36735436
5 As reported by the BBC. See bbc.com/news/business-36715806
Immediate tax issues to consider

Foreign exchange hedging: In a period of continuous volatility in foreign exchange rates, real estate owners, operators and investors should be particularly attentive to the risk that their assets and related hedging instruments (e.g., foreign exchange forward contracts) may produce income of a different character. For US tax purposes, returns on foreign exchange forward contracts are typically characterized as ordinary income, which cannot be offset against capital losses realized on certain underlying assets (e.g., long-term equity positions). This could result in significant character and timing impacts for US taxable investors and US managers receiving performance allocations from funds.

Tax points for further consideration

EU diversification: Existing EU-wide pass-porting mechanisms allow real estate owners, operators and investors that are authorized in one EU jurisdiction to operate in another EU jurisdiction without the need for additional authorization. In the event that the post-EU exit arrangements result in pass-porting mechanisms ceasing to apply to UK businesses (e.g., a UK manager of a UK real estate fund), alternative structuring arrangements may be worth considering. For example, depending on how the exit develops, firms may wish to consider establishing new entities in alternative EU jurisdictions and seeking appropriate authorizations. Any such restructuring will have tax implications, which will need advance consideration to enable the timely submission of any application for authorization.

Investment mandates and management/service agreements: Investment mandates and management and service agreements will need to be reviewed. For instance, if a UK real estate owner, operator or investor decides or is required to relocate certain management functions to an alternate EU jurisdiction, management and service agreements will need to be revised. The tax implications of novation of mandates and agreements will need to be considered on a case-by-case basis, including transfer pricing. In addition, to the extent that documentation for investment arrangements relies on certain tax clauses, the documentation may need to be reconsidered in light of the UK leaving the EU.

Human capital: Immigration was a key issue in the broader exit discussion. EU personnel residing in the UK for less than five years at the time of the UK’s exit from the EU may not be eligible for UK residency. This may require relocation of personnel from the UK to an alternative jurisdiction, or steps to adjust their UK immigration status. The process of relocating staff to and from the UK will become more complex, continuing the theme of increased requirements to monitor staff traveling internationally, from a tax and regulatory perspective. However, one should also note that managers may no longer be subject to the bonus caps in various EU directives as and when the UK formally leaves the EU. This will depend on what approach the UK wishes to take to bonus caps following EU exit.

Real estate funds and investors

Transfers in and out of funds: Depending on the regulatory settlement, UK investors may need to be transitioned out of non-UK EU funds, and non-UK investors may need to be transitioned out of UK funds. If this is the case, then consideration will need to be given to the local taxation of all investors being transferred between funds.

Specific EU taxes: Without the influence of the UK in political and economic negotiations, certain EU corporate and other tax initiatives may more likely come to fruition, such as the proposed common consolidated corporate tax base, financial transaction tax (FTT) or (if no FTT) a financial activities tax. Many of these measures would affect all funds investing in EU markets.

Specific UK taxes: Outside the EU, it will be easier for the UK to change specific domestic tax regimes. For example, the UK would be at liberty to re-impose 1.5% stamp taxes, which apply to shares issued into a
clearance service or to a depositary receipts provider, and which have been ruled by the European Court of Justice and UK tax tribunals as being contrary to the EU Capital Duties Directive.

**BEPS and other tax anti-avoidance measures:** Although there have been discussions to the contrary, it is expected that the UK will continue to push forward base erosion and profit sharing- (BEPS)-related initiatives on interest limitation and hybrids, although it is conceivable that the timetable for these changes will be pushed back. More broadly, thought needs to be given to the impact of BEPS and other anti-avoidance initiatives on tax systems of other EU Member States, particularly if business relocates from the UK to those other countries. In that context, firms will need to consider the longer-term tax outlook in those countries.

**Withholding taxes and treaty benefits:** UK investors may no longer be treated as “equivalent beneficiaries” for purposes of applying limitation on benefits tests under the US tax treaties with certain EU jurisdictions. It is also possible that a period of renegotiation of double tax treaties and withholding tax rates between the UK and other EU countries may occur.

**EU dividend withholding tax reclaims:** Many UK funds have EU dividend withholding tax reclaims pending with EU tax authorities and/or may suffer withholding tax contrary to EU law in the years prior to the UK’s formal exit from the EU. It is unclear how these claims would be treated by EU jurisdictions and/or the UK.

**Claims against Her Majesty’s Revenue and Customs (HMRC) based on EU law:** There are a number of cases in the UK and EU courts claiming certain UK tax rules are not in compliance with the EU freedoms (e.g., various cases related to value-added tax, Marks & Spencer claims for cross-border loss relief, and Franked Investment Income Group Litigation claims that non-UK dividends should not be taxable). While nothing immediately changes, certain members of the Leave Campaign stated in the run-up to the referendum that they would seek to prevent further repayments and interest being paid with respect to such cases. The outcome of this and the previous point may be something that would be addressed in the exit negotiations.

**EU Parent/Subsidiary Directive:** The EU Parent/Subsidiary Directive provides that EU Member States cannot apply withholding tax to dividend payments from an EU subsidiary to an EU parent, with such relationship defined by reference to a 10% ownership threshold. If this Directive no longer applies to payments to a UK parent, taxpayers will need to rely on existing tax treaties, which generally will allow for higher rates of withholding tax to be applied. Some of the management company structures that rely on the EU Parent/Subsidiary Directive may need to be reviewed.

**EU blacklist:** Many common fund jurisdictions (e.g., Jersey and the Cayman Islands) are not currently included in EU blacklist proposals, but this could change without the influence of the UK and its asset management industry in the EU. This would have potentially adverse consequences on capital flows between EU jurisdictions and those territories.

**General**

**Her Majesty’s (HM) Treasury and HMRC resource:** There is uncertainty on the resources available to HM Treasury and HMRC to process the required changes to UK tax law related to the UK’s exit from the EU, and on how this might affect existing consultations, law change, inquiries, updates to HMRC guidance, etc.

**General UK tax regime:** As well as the potential introduction of new measures and tax increases, there is uncertainty on the likelihood and timing of existing consultations (e.g., on loss relief and on changes to the UK substantial shareholding exemption), law changes, inquiries and updates to HMRC guidance.
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