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UK Real Estate Tax Changes: How are Commercial Property Lenders Affected?

A significant amount has been written about the proposals made in the November 2017 Budget by the Chancellor of the Exchequer in relation to the taxation of the UK commercial property sector. The bulk of this commentary has been directed towards investors in commercial property assets (by which we mean entities which purchase commercial properties, either directly or indirectly). We thought, therefore, that it would be helpful to produce some commentary that focusses on how commercial property lenders may be impacted by these proposals.

Overview of the Relevant Proposals

There are two features of the recent Budget that are relevant to commercial property lenders:

- the first is that UK non residents disposing of interests in UK commercial property, whether directly or indirectly, will be subject to UK tax on any capital gains from such disposals to the extent arising after April 2019 (the **"Capital Gains Feature"**); and

- the second is that UK non resident property companies will be brought into the charge to UK corporation tax from April 2020, rather than being subject to the charge to income tax. While this reduces the rate of tax on rental income applicable to such companies, it is expected that existing restrictions that apply to the deductibility of interest in calculating corporation tax liability will apply to such taxpayers (the **"Deductibility Feature"**).

The Capital Gains Feature

Documentation used in the context of UK commercial property lending transactions has not really made specific provision for tax on capital gains made by borrowers. The traditional reasoning has been that tax, in the UK at least, is an unsecured liability and has no statutory priority over the claims of secured lenders. This is coupled with a contractual obligation imposed on borrowers by lenders to ensure that they satisfy their tax liabilities and so, if a borrower has a tax liability that it needs to meet, the sponsor must ensure compliance, injecting additional funding if need be, or run the risk of a loan default.

There is still logic to this analysis notwithstanding the Capital Gains Feature, particularly when a lender is dealing with a reputable sponsor with which it has a meaningful commercial relationship. However, adopting the historic approach could expose lenders to incremental risk in certain situations. Suppose that a borrower owns five properties that it has financed pursuant to traditional loan documentation. In 2020, after the Capital Gains Feature has become effective, it disposes of one property at a price which results in a gain which would be taxable by virtue of the Capital Gains Feature. In accordance with traditional loan documentation, it pays the lender the "Release Price" (the aggregate of an allocated loan amount and a release premium), which is covered by the net disposal proceeds. It then pays the balance to the sponsor, as it is entitled to do under the loan documentation. Before the Capital Gains Feature becoming effective, a lender could legitimately take a relatively relaxed view of this situation: there was no UK tax to be paid on the gain and so there would be no need to require the sponsor to inject funds. Not so after April 2019, however. Unless the sponsor injects funds, based on responsible conduct, or there are sufficient surplus funds generated by the other four properties to enable tax liabilities to be met, the solvency of the borrower could be compromised.

Of course, responsible sponsors would not be expected to walk away from the obligations of their borrowers. That said, it may be prudent for a lender to consider whether to impose more discipline around the process of disposing of a property where a single loan is used to finance multiple properties. One relatively easy way of doing this would be to require that the Release Price includes an element which is sufficient to discharge tax liabilities arising from the gain. This amount could be held within the controlled account structure and be released by the security agent when the tax liability was due for payment. Another way is to formalise the sponsor's obligation to provide the necessary funding through a contractually binding obligation, though sponsor recourse is rarely popular.

The Deductibility Feature

As a general matter, in the context of UK corporation tax, above a minimum threshold of GBP two million of net interest expense, the deduction that a group is entitled to make for interest expense it incurs will be capped at the higher of:

- 30 per of the group's UK EBITDA; and
- the group's overall net interest to EBITDA ratio for external debt (i.e. debt provided by third parties) - the group ratio test.

This restriction is supplemented by additional rules which are aimed at preventing groups with the capacity to deduct interest payments from utilising that capacity by using shareholder debt. There are, however, limited exemptions that mitigate the impact of restrictions on interest deductibility, including one which is specifically aimed at loans made to UK property rental businesses – this is part of the "public infrastructure exemption", so called. This is relevant in the context of the Deductibility Feature.

In addition, there are rules, known as the "hybrid mismatch rules" which may add another layer of complexity in analysing a borrower's position in terms of interest deductibility. These rules are designed to prevent groups exploiting the different treatment of financial instruments or entities to obtain a cross-border tax mismatch (classically, obtaining a tax deduction in one jurisdiction but not suffering a corresponding tax charge in another). As a very broad generalisation, these are unlikely to apply to typical third party lending.

It is likely that interest payable by a borrower in respect of third party debt incurred to finance a UK commercial property transaction will remain deductible in determining a borrower's exposure to UK corporation tax as a result of the application of the group ratio test or the public infrastructure exemption. However, this should not be treated as a forgone conclusion as the applicability of the available exemptions is subject to a number of detailed conditions that must be satisfied before the exemption can be relied on. Lenders may wish to consider requiring that borrowers provide satisfactory analysis as to whether they will obtain deductions for interest expenses and, where they must satisfy conditions or make elections, imposing a contractual framework requiring them to do so. If a borrower claims a deduction for interest expenses to which it is not entitled, it will face the possibility of a demand for back taxes. This would clearly impact upon the solvency position of that borrower absent sufficient sponsor support or surplus income.

On the other hand, interest on shareholder debt provided on a subordinated basis to fund the sponsor's equity contribution is unlikely to be deductible after 2020 given the Deductibility Feature. The traditional approach to loan documentation is based on an assumption, implicit if not explicit, that all arm's length interest payable in respect of shareholder debt will be deductible and so there is no need for additional rigour in the contractual rules beyond the obligation imposed on the borrower, and described above, to discharge its tax liabilities. While it may be appropriate for a lender to rely on a responsible sponsor ensuring that a borrower discharges its tax liabilities, there may equally be a case for a lender requiring that a borrower maintains a certain amount of liquidity within the controlled accounts so that it can discharge its corporation tax liabilities.

We have also started seeing another interesting trend in corporate transactions which are already affected by the principle underlying the Deductibility Feature. This is that sponsors which are no longer able to claim deductions for shareholder debt are in some cases offering deeply subordinated debt opportunities to third party mezzanine debt providers which may not have existed previously (funding may instead have been sought in the form of equity co-investment for example), thus benefitting from an improved interest deductibility position. It will be interesting to see if this trend develops and if it catches on for commercial property transactions.

The Next Steps

Investors in UK commercial property are already examining carefully how to respond to the proposals made in the last Budget. It is likely that sponsors will take these changes into account in structuring new transactions (for example, using true equity or additional mezzanine debt rather than shareholder debt to respond to the Deductibility Feature or locating borrowing groups in jurisdictions where the double taxation treaty with the UK does not currently allow the UK to tax indirect UK real estate – related capital gains). Lenders may also be approached with requests to restructure existing transactions. These could relate to changing the nature of the borrowing entity or front loading capital expenditure or other asset management initiatives so that they are reflected in the value of properties before April 2019. However, one step that will not be open to sponsors is relocating existing companies to favourable double taxation treaty jurisdictions to mitigate the impact of the Capital Gains Feature – this has been prevented through an explicit anti-forestalling rule introduced in the Budget.

In any event, it may be appropriate for lenders to consider whether the time has come to develop the traditional approach to loan documentation described above in order to reflect the developments in the UK tax regime. This is particularly true of mezzanine lenders who have a greater sensitivity to leakages of cash flow and matters that could impact on the solvency of the borrowers. Many loans that are being negotiated at the current time will still be outstanding when these changes are introduced.