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EMERGENCY BUDGET - REAL ESTATE ALERT

The Emergency Budget at a Glance

Today's Budget announcement introduces a raft of reforms that will impact on the real estate sector.

CORPORATION TAX RATE

The headline rate of corporation tax (applying to businesses with profits in excess of £1.5m) is to be reduced from 28% to 27% with effect from 1 April 2011. The rate will decrease by 1% each year thereafter until it reaches 24% with effect from 1 April 2014. The small companies rate of corporation tax (where profits are below £300,000) is to be reduced from 21% to 20% with effect from 1 April 2011.

Comment

The corporation tax decrease is a welcome change, although will need to be viewed against the backdrop of a reduction in the rate of capital allowances and the VAT increase.

CAPITAL ALLOWANCES

The rate of writing down allowances ("WDAs") for plant and machinery in the 'main rate' pool is to be reduced from 20% to 18% and for the 'special rate' pool, is to be reduced from 10% to 8%. This is with effect from April 2012.

The Annual Investment Allowance, which is a provision allowing (in general terms) the first £100,000 of a business' capital expenditure to be fully deductible for tax purposes, is being reduced from £100,000 per year to £25,000 per year from April 2012.

Comment

Capital allowances are a form of annual tax relief for taxpayers who incur expenditure on certain types of plant and machinery. The expenditure is allocated to the main or special rate pool depending on the type of plant and machinery. For example, so-called 'integral features' (which includes electrical systems, lifts, escalators, cold water systems, space or water heating systems and external solar shading) all fall within the special rate pool. The taxpayer will then be entitled to an annual WDA, depending on the rate applicable to the relevant pool.

The Government changes mean that taxpaying property investors and occupiers who incur expenditure on plant and machinery will now have their tax relief spread over a longer period, and therefore takes some of the gloss off the reduction in corporation tax rates. Certain sectors, such as manufacturing, retail and hotels/leisure will be hit hardest by this change.

Of course, these changes are not a concern for tax exempt property investors such as pension funds and Real Estate Investment Trusts.

REAL ESTATE INVESTMENT TRUSTS (REITs)

The announcement in the first Budget in 2010 has been confirmed today - following extensive lobbying from the industry, UK REITs will be able to issue stock dividends in lieu of cash dividends (in order to meet

the 90% distribution requirement).

Comment

This announcement was largely expected, but will nevertheless be welcomed by the REIT industry.

CAPITAL GAINS TAX (CGT)

The rate of CGT for higher rate taxpayers is being increased from 18% to 28%, although 'entrepreneur's relief' (which can reduce the rate of tax to 10% in certain circumstances) will now apply to the first £5m of gains (previously the first £2m). The changes have effect from 23 June 2010.

Comment

A flat rate of CGT has the advantage of simplicity, something all taxpayers welcome. But a flat rate that makes no allowance for inflation is only reasonable as long as the rate itself is reasonable. Increasing the rate by more than half from 18% to 28% for higher rate taxpayers will be seen by many as unreasonable, bearing in mind long-term investors will be taxed on up to 30 years of inflationary gains. In many cases if they sell an investment they'll make a loss in real terms and yet still pay 28% tax on the illusory gain.

There is good news for entrepreneurs. Not only did the Chancellor maintain the distinction between business and non-business assets, but he extended entrepreneurs relief. The first £5 million of gains on the sale of a business will now be taxed at just 10%. £5 million is a sensible level compared to the previous limit of just £2 million. And a 10% tax rate for entrepreneurs compared to a headline rate of 28% is surely enough incentive for most entrepreneurs. There will, of course, be understandable concern from those who recently sold their business for more than the previous £2 million limit although the £3 million balance will be available for future sales: a clear encouragement for serial entrepreneurs. However, this relief will be of limited application in the property investment scenario, unless (say) an individual is selling a property at the same time as a business (which occupied the property).

The increase in CGT may discourage investors from selling assets, ironically resulting in a smaller tax take overall. If buy-to-let and second-home owners are discouraged from selling their properties, that could lead to fewer properties being sold, resulting in lower Stamp Duty Land Tax revenues and higher property prices. This is hardly a recipe for boosting government coffers or promoting housing market stability.

VAT

The standard rate of VAT is being increased to 20% with effect from 4 January 2011 (with extensive rules designed to stop certain 'forestalling' techniques).

Comment

Clearly the increase in VAT will present an additional cash flow risk to property investors, tenants and developers, and will be a real cost to those business which cannot recover all or part of their VAT costs (for example banks and other businesses in the financial/insurance industries).

It is notable that the Government has resisted the temptation to reduce the rate of VAT arising on renovations and refurbishments of residential properties (since VAT will usually be an absolute cost here). It was hoped that a change would help kick start the private rented sector, for example. However, the Government has maintained the existing zero-rates, which apply principally to the construction of new dwellings and this is to be welcomed.

STAMP DUTY LAND TAX (SDLT)

No major announcements have been made in relation to SDLT save for two things. First, the Government is to 'review the effectiveness of the stamp duty land tax relief for first time buyers'. Second, and more vaguely, the Government has announced that it will 'examine whether further changes to the rules on stamp duty land tax on high value property transactions are needed to prevent avoidance in this area'.

Comment

The Budget today is more notable for what it did not do in relation to SDLT rather than what it did do. Many were bracing themselves for announcements which developed the proposals set out by the Liberal Democrats in their election manifesto (the Coalition Agreement having promised to pursue this). In particular, there was concern that rules could be brought forward to tax the sale of shares in property owning SPV companies (or indeed the sale of units in unit trusts) at rates of tax which equalled that which would have arisen had the property itself been sold.

Whilst no formal Consultation Document has been issued, the Government does not appear to have limited its new consultation to residential property (which was the case when this issue was last looked at in a Consultation Document issued in December 2007). So developments in this area are eagerly awaited by both the commercial and residential sectors, particularly by those property investors with extensive (often offshore) corporate holding structures.

FURNISHED HOLIDAY LETTINGS

The Government has confirmed that the advantageous tax rules applying to furnished holiday lettings will be retained (reversing the previous Government's policy). The Government will consult over the summer about how the UK rules can be brought into line with EU law.

Comment

This was an expected announcement, but will be welcomed by investors in holiday lets who will remain eligible for the advantageous tax treatment of the existing regime (the rules are advantageous, because the investor is taxed as if the activity were a trade, not an investment activity).

GENERAL ANTI-AVOIDANCE RULE

The Treasury has issued a paper entitled "Tax policy making - a new approach". The paper sets out various questions for discussion over the summer, and includes a commitment to work with interested parties to develop, amongst other things, a general anti-avoidance rule for tax purposes.

Comment

This is an important consultation, although many practitioners have traditionally feared the 'blunderbuss' approach of a GAAR, fearing that it will catch many bona fide transactions. Taxpayers are encouraged to make representations to the Government in this regard.

For further information, please contact **Jonathan Legg**, Real Estate Tax Partner on **jonathan.legg@mishcon.com** or +44 207 440 7092.

IMPORTANT: This briefing note is only intended as a general statement of the law and no action should be taken in reliance on it without specific legal advice. Release Date: 24 June 2010