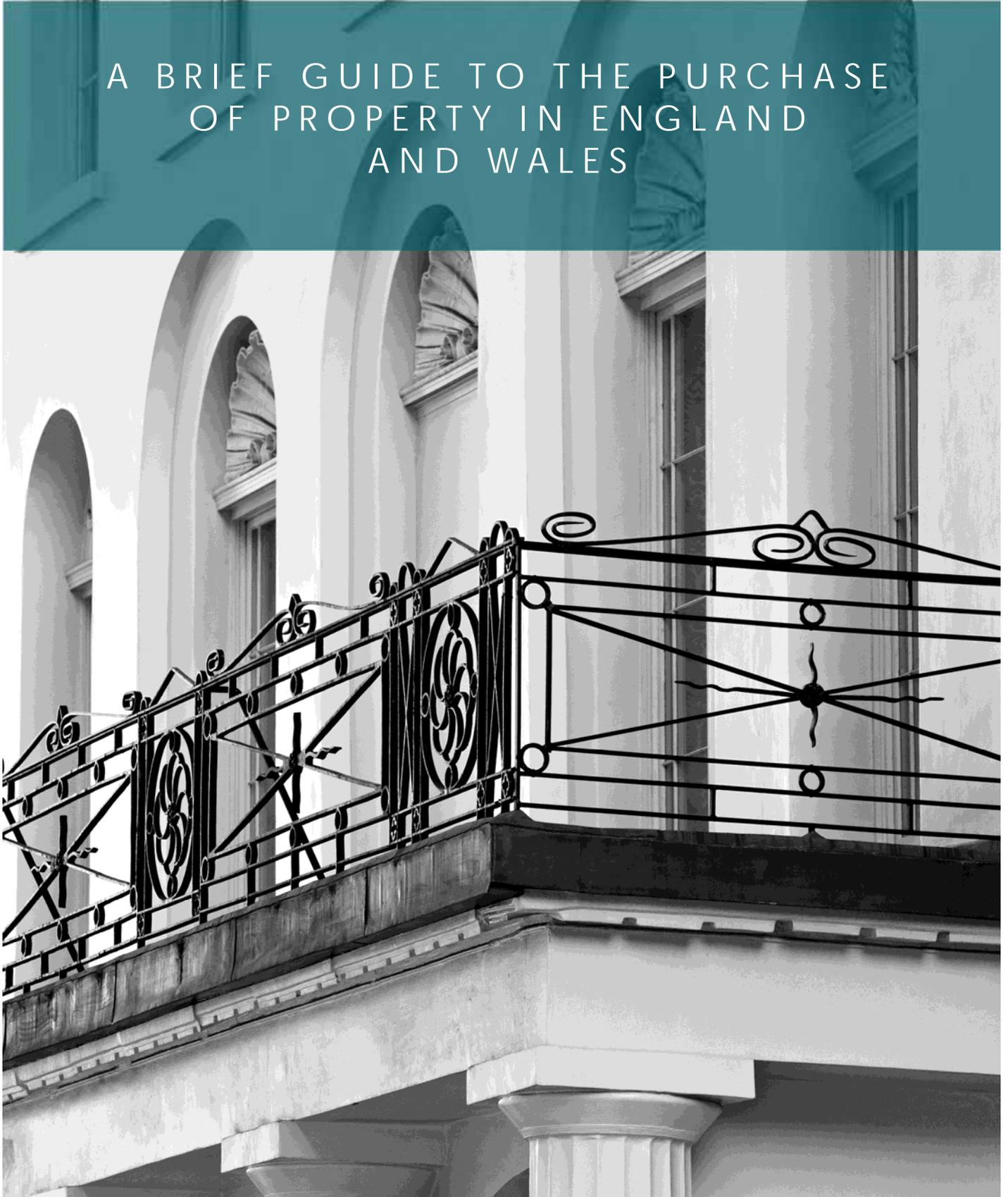


WATSON FARLEY
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A BRIEF GUIDE TO THE PURCHASE
OF PROPERTY IN ENGLAND
AND WALES



A BRIEF GUIDE TO THE PURCHASE OF PROPERTY IN ENGLAND AND WALES

England and Wales have historically had a dynamic, flexible and transparent property market, offering a broad variety of investment options. Overseas purchasers in particular are increasingly assessing opportunities in England and Wales as potentially attractively priced assets, particularly in light of the lack of restrictions on foreign nationals or overseas companies buying or renting property (subject only to tax implications).



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Part A of this Guide seeks to provide a legal background for overseas entities or individuals considering investing in or renting residential or commercial property in England or Wales, either to occupy themselves or for investment purposes.

Part B addresses issues to consider relating to commercial leases and business rates payable by a commercial occupier.

Part C discusses some of the tax considerations which may be relevant to overseas purchasers.

PART A: OWNERSHIP OF LAND



The two most important forms of ownership are:

- **Freehold**

Where the property (both land and structures) is effectively owned by the buyer. A buyer may choose to own the freehold as this gives the most control, has a capital value and will enable the grant of leases to secure an income stream. However, it should be noted that freehold ownership may still be subject to certain covenants, for example, restricting the use of the property and/or rights of others, such as rights of way for third parties across the property.

- **Leasehold (i.e. leasing or renting the premises)**

Where the leaseholder's ownership of the land is contractually limited in time to the length of the term of the lease. The lease will be granted out of a freehold or superior leasehold estate. Depending on the rent payable to the landlord of the lease, long leases will usually have a capital value. The lease may also allow the tenant to create underleases.

Land can be held by more than one person in one of two ways; either as a joint tenancy or a tenancy-in-common. The legal ownership can be held by a maximum of four owners. In the case of individuals, a joint tenancy is a form of ownership where normally, should one owner die the property will automatically vest in the surviving owner(s), regardless of the terms of the deceased's will.

A tenancy-in-common, however, is a form of ownership where on the death of one of the joint owners, the relevant share in the property will form part of the deceased's estate and will pass to their beneficiaries by their will (or the rules set down by law where there is no will).

Leasehold

Key elements

A lease is a contract between a landlord and tenant. It is characterised by the landlord granting the tenant exclusive possession of the property for a fixed time (i.e. for a specified term or a period which is capable of being brought to an end by notice).

Main types of lease

The ground lease

This is a (normally residential) long lease often granted for more than 99 years, usually for a one-off sum, called a "premium", with a nominal rent payable (sometimes called a "peppercorn") throughout the rest of the term. A ground lease may be perceived to be closer in nature to a freehold, owing to its capital value. Apartments/flats are normally sold or held on a long lease.

The rack rent lease

This is the most prevalent form of a commercial occupational lease, usually granted for around 5-10 years. The tenant will pay a full-market rent, often quarterly, with rent review provisions and usually with no premium.

Short term residential occupational leases

These generally take the form of an Assured Shorthold Tenancy, whereby at the end of the lease period the landlord is entitled to possession of the premises.

Registered land and how land is transferred

Registered land

The majority of land in England and Wales is registered at the Land Registry. The register is a matter of public record and the title is guaranteed. Most (but not all) third party rights will be shown on the register e.g. mortgages.



How is land transferred?

A typical sale and purchase transaction is a two-stage process involving an exchange of contracts between the buyer and the seller followed by completion of the legal transfer. A seller's solicitor will issue a draft sale contract, which will be negotiated and then exchanged with a deposit usually being paid. This is the point of no return, when both parties commit themselves to complete on a certain date. Up to this point, either party can withdraw without any liability to the other side. The bulk of the work comprises title due diligence up to the exchange of binding contracts.

Following exchange of contracts, the transfer of the property from the seller to the buyer is made by completing the transfer deed and by complying with

Land Registry registration requirements. Completion is, in effect, moving day, when the money is paid to the seller's solicitors and the keys to the property are handed over.

There is normally a 28 day period between exchange of contracts and completion/closing of the sale and purchase.

Principle of "caveat emptor"

In land sales in England and Wales, the principle of "caveat emptor" ("let the buyer beware") is key and places the responsibility for due diligence and searches relating to a property on the buyer. It is normally the task of a buyer's solicitor to consider and negotiate the legal documentation. The buyer's solicitor will also seek to discover as much information as possible about the property before contracts are exchanged. This is achieved by examining the title documentation and through a variety of searches and enquiries, including but not limited to:

- **Local search** – list of enquiries about property sent to local authority which

includes questions about planning, highways, drainage etc.

- **Environmental search** – historical information about previous uses of the land.
- **Preliminary enquiries** – questions about the property which are sent to the seller's or landlord's solicitors requesting information about disputes with neighbours, use of property etc.
- **Physical examinations** – a physical survey of the property should be arranged by the buyer and carried out by a surveyor.

Where contamination may be an issue, investigations of the land can be carried out by environmental consultants.

It should be noted that on exchange of contracts a 10% deposit is normally paid (although subject to negotiation) to either the seller or the seller's solicitors. In the event of the buyer's default and failing to complete, in addition to other claims the seller may have, the seller would normally be entitled to retain the deposit.



Planning

Prior to making most alterations, erecting new buildings or changing the use of an existing building, the relevant owner or occupier must contact their local authority's planning department in order to obtain planning permission. Planning applications in England and Wales are administered by the local authority covering the area in which the particular building or site is located.

The system in England and Wales is largely discretionary and therefore flexible. The usual time-frame for a straightforward planning application to be considered is between eight and 13 weeks from the formal application, depending on whether it is treated as a major application. The appeals system also follows a comprehensive process.



Construction

An essential component of any due diligence prior to acquiring a property (and prior to any exchange of contracts) is to investigate matters which relate to the actual construction of the property. This tends to be more relevant for recently constructed properties. As well as the buyer carrying out a survey, the buyer's solicitor should ask the seller's solicitor to provide details on matters such as when the property was constructed, what modifications (if any) have been carried out (and when), and whether any of the construction contracts can be inspected.

Subject to the age of the property (or the age of any modifications), the buyer should enquire as to whether any warranties or guarantees are available (or could be provided to a buyer) from the builder or developer, which may give a buyer certain contractual rights in the event that any defects became apparent in the property post completion.

In respect of newly built residential properties, NHBC (National House Building Council) certificates (if provided) provide certain guarantees on build quality, which give a buyer a degree of



peace of mind. NHBC guarantees primarily cover the structural integrity of a newly built residential property. They also ensure that a developer is responsible for all repairs during the first two years after completion.

Tax implications of acquiring an interest in property

Value Added Tax ("VAT") Commercial property transactions may be subject to VAT. Whether a commercial property transaction is subject to VAT will depend on several factors, mainly being whether it is regarded as a "new" property or whether the seller has opted to tax the property (formerly known as an election to waive exemption from VAT). VAT is currently charged at 20%. VAT is not usually charged on the premium or rent paid on a residential transaction, since residential property transactions are generally exempt from VAT or "zero rated".

Stamp Duty Land Tax ("SDLT")

SDLT is a mandatory tax payable by the buyer on the purchase price, on completion or substantial performance of the contract, whichever is earlier.

Current SDLT rates are listed at the back of this Guide. On the grant of a lease, SDLT is also payable on both the premium and rental payments.

There are a number of transactions which may be exempt from SDLT. Detailed consideration of these transactions is beyond the scope of this

Guide, although Watson Farley & Williams can provide advice as required.

Council Tax

Council tax is a property tax that residential occupiers pay towards the costs of local government. Details of the council tax for the relevant property would need to be obtained from the local authority for the area.

Capital Gains Tax

On the sale of a property, the seller may be liable to pay capital gains tax. Capital gains tax is chargeable on the "gain" element of the sale proceeds. Liability to pay capital gains tax partly depends upon whether the property is commercial or residential and whether a relief applies (for example, capital gains tax is not usually payable where an individual disposes of a residential property that is his own or main residence).

Inheritance Tax

UK inheritance tax ("IHT") may be chargeable on the death of an owner of UK property. In certain circumstances, IHT may also be chargeable when a trust or gift of the property is made during the owner's lifetime. A detailed consideration of IHT is beyond the scope of this Guide, although Watson Farley & Williams can provide advice as required.

Tax on rental income

Broadly, an individual or company will be liable to UK tax on income generated by UK property whether or not that individual or company is UK tax resident.

Under the "Non-resident Landlords Scheme", UK tax (currently at 20%) is deducted at source from rental payments, before they are paid to the non-resident landlord.

Capital allowances

Capital allowances provide tax relief for the expenditure of certain capital items. Where available, a business can deduct capital allowances from its taxable profits, therefore reducing its liability to tax. There are many types of capital allowances, the most common being those available for expenditure on: (1) plant and machinery (such as kitchen equipment); and (2) integral features (such as lifts and air conditioning units).

Capital allowances operate to enable a business to gradually write-off the cost of certain qualifying capital assets. Under the capital allowances regime, a business can apply an annual writing-down allowance (WDA) against expenditure on such assets. Broadly, plant and machinery is eligible for a WDA of 18% whilst, integral features are eligible for a WDA of 8%. Exceptionally, in certain circumstances, a 100% first year allowance may be available.

PART B: COMMERCIAL LEASES

Pre-lets

Tenants can rent premises that are already available or may be entitled to enter into "pre-let" agreements with developers to lease premises prior to the carrying out or completion of construction work (enabling the future tenant to have input in specifying the design, layout and fittings of the building).

Security of tenure

In some cases where a tenant occupies premises for business purposes, statute grants them the right to renew their lease on largely identical terms (subject to a rent calculation ("rent review")) at the end of the lease (the intention being to protect the tenant's goodwill at the premises established whilst in occupation).

Certain rights to compensation may be available in the event that the landlord is able to rely on one or more of seven grounds to refuse to renew the lease (e.g. if it requires occupation of the premises for its own use or wishes to redevelop the property).

Nevertheless, it is common for the parties to agree to exclude security of tenure and right to compensation by "contracting out" of the statutory provisions, which is a relatively straightforward procedure. If the lease is contracted out then the tenant must vacate the premises when the lease expires, with no protection from statute and no right to compensation.

Consents

In some leasehold property, the consent of third parties, such as a superior landlord, may be required to the sale/transfer.

Rent review

Where leases are granted for more than five years, it is standard to provide for a rent review every third or every fifth year. These reviews can be based on the open market rent which would be payable for a lease of the property on similar terms, may be linked to the Retail Prices Index or (less commonly) on fixed increases. Such provisions are almost always for "upwards only" reviews, which means that the rent cannot go down on review.

Full repairing and insuring lease

The majority of leases of commercial premises in the UK are on a full repairing and insuring basis ("FRI lease") whereby the tenant is liable for the upkeep and decoration of the property and the landlord's costs of insuring the building. This means that prior to entering into any lease the tenant is strongly advised to carry out a full survey as the tenant will be obliged to put the property into full repair. A survey should highlight any defects and these can be excluded by negotiation from the lease liabilities.

Service charge

Where a property is let to several different tenants the landlord will retain responsibility in relation to the structure and the common parts of the building. He will recover these costs from the tenant through charging a fee called a service charge. The amount of service charge paid is generally proportionate to the size of the tenant's individual unit, in relation to the rentable space in the whole building.



Break clauses

Some leases include break clauses giving the landlord and/or the tenant the option to end the lease before its expiry date. These clauses usually specify how much notice has to be given and may have financial implications. All conditions for the exercise of the break must be satisfied, otherwise the right to break will be lost. It is advisable to consult with a member of the Real Estate group at Watson Farley & Williams prior to finalising heads of terms on a lease or purchase of a property.

Privity of contract

Where a lease is transferred to a new party, the original tenant will be subject to different liabilities dependent on the date of the lease.

For leases signed before 1 January 1996, the original tenant remains legally responsible for the rent and other commitments for the duration of the lease, regardless of whether they transfer the leasehold interest to a third party.

Subject to certain exceptions, for leases signed on or after 1 January 1996, the tenant will not remain liable for these commitments unless the landlord requests the tenant to sign a guarantee, known as an "AGA". If an AGA is required, the tenant will remain liable for these commitments during the ownership of the new tenant, but not the new tenant's successors.

Sometimes a landlord may request a guarantor (or other security) for performance of the tenant's obligations.

Business rates

Business rates are a property tax that business occupiers pay towards the costs of local government services. They typically range from £20 to £130 per square metre (approximately £2 to £13 per square foot).

PART C: UK REAL ESTATE & TAX: INBOUND INVESTMENT



It is important to structure inbound property investments carefully so that:

- a. the investor's expected return can be properly modelled (both on-going cash flows and exits are directly impacted by tax); and
- b. the transaction is appropriately assessed in the light of the changing global tax landscape.

The tax treatment of investing in UK property will depend on the type of asset (e.g. residential or commercial) and the type of investor (e.g. fund or individual).

The UK tax treatment of overseas traders and developers is different from investors. This document applies to investors only.

Acquisition of UK properties

Stamp duty land tax (SDLT)

SDLT is a transfer tax chargeable on the acquisition of certain interests in land. The rates of SDLT vary significantly depending on the type of property, the type of investor and the purchase price or other consideration (e.g. rent).

For example, SDLT ranges from:

- 0 – 12% on residential property, with a flat rate of 15% for some purchases by a company not carrying on a particular property investment business and from April 2016 a 3% surcharge both on certain purchases by companies or trusts and on the purchase of additional residential properties by individuals; and
- 0 – 5% of the purchase price on commercial property (and, on grants and some transfers, 0 – 2% on the NPV of the rent).

VAT

VAT is not generally payable on the acquisition of UK residential property. The acquisition of UK commercial property is generally exempt from VAT, unless:

- the building is unfinished or new; or
- the seller has "opted to tax" the property,

but, that said, it may be possible to acquire such buildings/properties without a VAT cost if the transfer constitutes a going concern for VAT purposes.

On-going investment in UK properties

General principles

Non-UK residents are generally subject to UK income tax on investment rental income, net of certain allowable deductions.

A non-UK resident company is subject to basic rate income tax at 20%; whereas, a non-UK resident individual is subject to UK income tax at up to 45%.

So, there can be an advantage to investing through a company – at least in the case of an investment in commercial property or an investment in the course of certain bona fide property rental businesses.

However, recent changes with a view to discouraging "enveloping" residential properties and perceived SDLT avoidance (e.g. the ATED, ATED-related CGT and 15% SDLT – see below) mean that will not necessarily be the case for other investors in residential property.

Rental income is taxed by reference to the profits of the UK rental business and determined in accordance with commercial accounting principles.

Withholding from rent

Tax is withheld at the basic rate (20%) on gross rental payments (i.e. before allowable deductions) to non-resident landlords, unless a successful application is made to the UK tax authority (HMRC) by the landlord.

Allowable deductions

Most expenses of a UK rental business (e.g. agent's fees, advertising and maintenance costs) tend to be tax deductible, as long as they are incurred wholly and exclusively for the purposes of the business and are not capital.

Interest

Currently, financing interest is generally deductible as long as, in the case of a loan from a connected person, the amount of the loan and interest rate are arm's length.

The Government has announced that it will bring in new restrictions on interest deductibility as a result of the OECD's "BEPS" project – but, as yet, it is unclear whether those will apply to non-resident landlords.

Interest payments (both to third party financiers and connected persons) are potentially subject to UK withholding tax at 20% – but full and partial exemptions can apply in some circumstances.

Capital allowances

Tax deductions are not generally available for depreciation – but "capital allowances" (essentially the "tax equivalent" of depreciation) for qualifying capital expenditure on certain assets can in some circumstances be deductible at 18% or 8% (depending on the asset) on a reducing balance basis.

VAT and rent

VAT is not generally levied on leases of residential property – so there is no need to increase rentals to take account of VAT.

The position for commercial property is a little more complicated. In some circumstances property owners may opt for leases of their property to be subject to VAT (which allows them to recover VAT on some of their costs) and then pass on that VAT cost to the lessee.

Annual tax on enveloped dwellings (ATED)

The UK levies an annual tax on residential properties owned through corporate vehicles and an ATED-related CGT charge – though there are some helpful exemptions, including for certain bona fide property rental businesses.

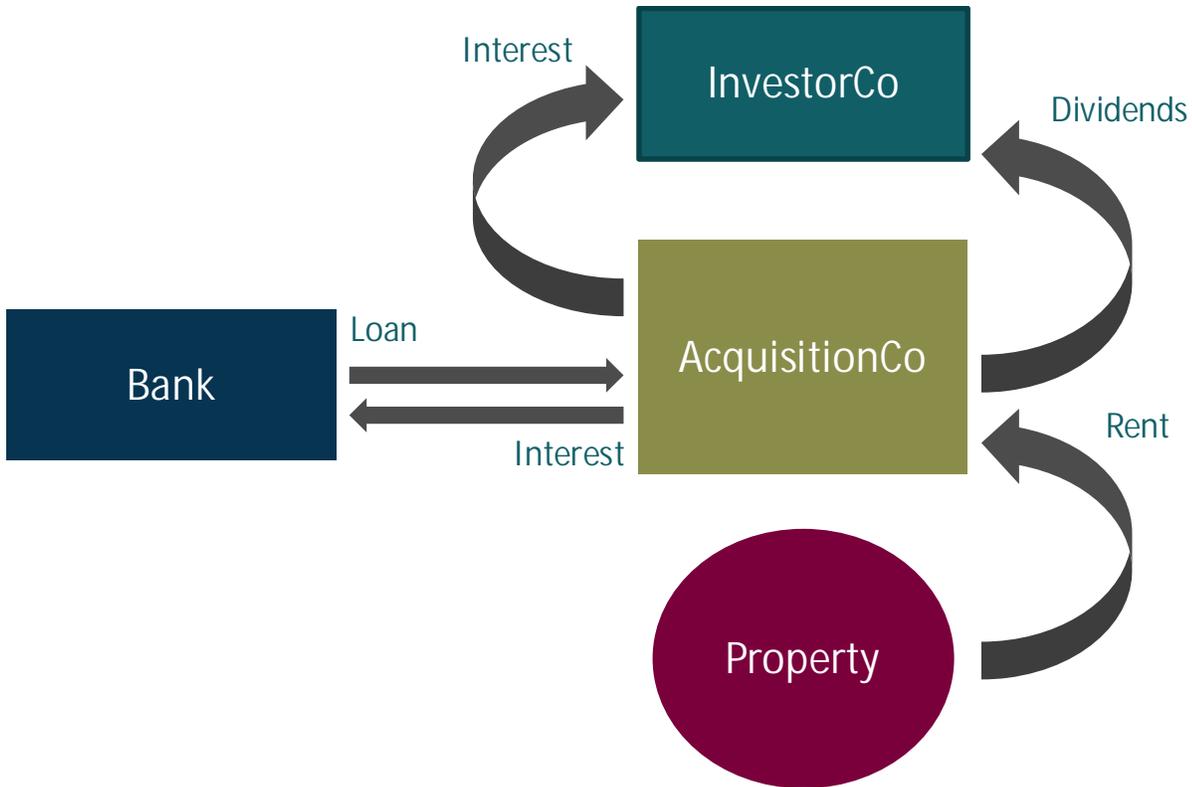
The ATED applies at a fixed annual amount based on the value of the property held – the ATED currently applies to properties valued at over £500k.

Implications for an individual's tax residence

Merely holding UK property should not make an investor UK tax resident. But, occupation of the property could (and could therefore bring the individual's non-UK income within the UK income tax net) in certain circumstances.



Typical structure for an overseas investor acquiring UK commercial property



Here, the investor might establish a local special purpose vehicle (AcquisitionCo) outside the UK.

Using an SPV in this way allows flexibility on exit (e.g. the ability to sell a proportion of the property investment and not the whole asset), can in some circumstances reduce the transfer taxes and can allow for specific borrowing at the level of the asset.

AcquisitionCo may be owned by a holding company in order to consolidate a number of underlying real estate investments.

It is important in these structures that AcquisitionCo is neither treated as trading nor resident in the UK. Special care on implementation will generally be required here.

Tax treatment on exit

Capital gains tax (CGT) and ATED-related CGT

A non-UK resident that is not trading through a permanent establishment in the UK (as should typically be the case on a pure investment) is:

- not subject to CGT on a disposal of commercial property;
- subject to CGT on a disposal of residential property (generally at 28% for individuals and 20% for

companies), unless ATED-related CGT applies (as to which, see below) or a relief from CGT is available; and

- where it is a company, subject to ATED-related CGT on a disposal of residential property with a value of more than £500k which has been subject to the ATED charge (see above, in particular the helpful exemption for certain bona fide property rental businesses).

Inheritance tax (IHT)

UK property is an asset for IHT purposes and will therefore constitute part of an individual's estate on death. The current rate of IHT on death is 40%.

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