

UPDATE

# Non-resident CGT on UK Commercial Property – Confirmation of Relief and Exemptions for Offshore Funds and Property Unit Trusts

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Countdown to April 2019

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## Background

In the November 2017 budget the UK government signalled its desire to impose a charge to UK capital gains tax (CGT) on gains on direct and indirect disposals of UK commercial property by non-UK residents from 6 April 2019. This represents the application of CGT to a non-resident's capital gains (NRCGT) on UK commercial property for the first time since the introduction of CGT in 1965. The charge will arise not only in relation to disposals of direct holdings of UK commercial property but also, in some cases, to 'indirect' disposals of 25%+ interests in 'property-rich' holding vehicles such as companies and unit trusts.

That November 2017 announcement was accompanied by an HM Revenue & Customs (HMRC) and HM Treasury (HMT) consultation document which drew significant industry responses. Concerns were raised about potentially prejudicial treatment of commonly-used, income tax transparent, offshore real estate funds, JPUTs and GPUTs, and the tax exempt investors (such as pension schemes) investing heavily in UK real estate through those structures. Respondents highlighted that investors in those vehicles could suffer multiple tax charges on the same disposal, prejudicing exempt investors in formerly tax transparent structures. In July, HMRC and HMT acknowledged those concerns and offered proposals for welcome relief for certain income transparent overseas collective investment vehicles (CIVs), including offshore funds, JPUTs and GPUTs.

## Summary of New Provisions

Following a subsequent period of collaborative industry consultation, the UK Finance (No.3) Bill published on 7 November 2018 contains the UK legislation implementing the new NRCGT measures, and confirms the relief offered to overseas CIVs. It confirms that certain income transparent and UK property rich offshore CIVs will be able to elect for (continued) transparency for the purpose of NRCGT (the **Transparency Election**), and that certain widely-held overseas CIVs (whether currently transparent or opaque) will be able to elect for exempt treatment (the **Exemption Election**) in the alternative, whereby gains by the fund or within its structure will not be taxable, but the fund's investors will be taxed on disposal of their interest in the fund.

The default treatment of UK property rich offshore CIVs that do not make an applicable election is that they will become persons chargeable to NRCGT on gains relating to direct and indirect UK commercial property investment **so, depending on the identity and tax status of an offshore CIV's investors, the making of an election, where available, is likely to be desirable for many offshore property unit trusts and funds.** Helpfully, the new legislation confirms that offshore CIVs that are partnerships will remain transparent for gains and will not, therefore, have to make such an election.

The new legislation also contains amendments to the exemption regime already available to UK Real Estate Investment Trusts (REITs), which includes certain offshore companies established and operating as such. Essentially the existing exemption, whereby UK REITs are not subject to CGT on direct disposals of UK

property, will be extended to apply to disposals of shares in UK property-rich companies held by a REIT (including an offshore REIT).

**This briefing summarises the two new elective regimes available to offshore CIVs as they consider making the necessary elections in the run-up to 6 April 2019, and the helpful expansion of the UK REIT exemption, and provides guidance to investors, managers (including managing trustees) and administrators of such structures on next steps and actions to be considered.**

Subject to the making of the required elections, these helpful provisions address initial fears that the CGT transparency of certain offshore structures might be compromised and underline their continuing utility for those (particularly tax exempt) investors seeking a familiar, tax transparent structuring vehicle for investment in UK commercial real estate.

In light of (i) the ability to sustain the CGT transparency of offshore CIVs (by election) and REITs as described in this briefing, (ii) the ability of any non-resident UK property rich entities subject to the new NRCGT charge to rebase property values as at 5 April 2019; (iii) the movement of non-UK resident corporate landlords (**NRLs**) from the UK income tax regime to the UK corporate tax regime only from April 2020, and (iv) the anti-forestalling measures, back-dated to November 2017, which prevent avoidance by restructuring through double tax treaty jurisdictions, the rationales for sustaining the use of offshore structures to hold UK commercial property (which also include unparalleled legal and regulatory flexibility) hold good.

## **Relief for Offshore Collective Investment Vehicles – Making a Transparency Election or Exemption Election**

### **Defining a CIV**

In determining whether the Transparency Election or the Exemption Election could be made by a particular UK property rich offshore vehicle, the starting point is to identify whether the vehicle falls within the relevant definition of a CIV. A CIV will include:

- a "collective investment scheme" (**CIS**) as defined in section 235 of the UK Financial Services and Markets Act 2000;
- Alternative Investment Funds (**AIFs**) as defined in regulation 3 of the UK Alternative Investment Fund Managers Regulations 2013; and
- to the extent not already covered by the AIF definition, a UK REIT within Chapter 12 of the UK Corporation Tax Act 2010, and overseas companies that meet a description intended to include the overseas equivalent of UK REITs (i.e. it is "non-close", at least half of its income is property income from long-term investments, it distributes all (or substantially all) of its property income annually, and it is not liable to tax on that income under the law of any territory in which it is resident).

This CIV definition is helpfully broad, and should capture most UK property rich JPUTs and GPUTs (which are generally constructed as a CIS, even where they are joint ventures) and widely-held offshore funds, but where a CIV wishes to make a Transparency Election or Exemption Election, care should be taken (by reference to UK regulatory advice) to ensure the vehicle is a CIV and can make a relevant election as described below.

In some cases, a CIV may be able to make either form of election and therefore have a choice when deciding which election to make. We explore below the dynamics behind deciding which election to make in such cases.

### **Non-application of the 25% test to interests in CIVs**

One consequence of a UK property rich offshore vehicle being classified as a CIV is that the 25%+ substantial indirect interest requirement referred to above is dis-applied in relation to disposals of interests in the CIV. This means that investors holding less than a 25% interest in the CIV will, *prima facie*, be within the scope of the NRCGT indirect charge unless otherwise tax exempt. The usual 25% indirect interest requirement may be re-applied for certain pan-European or global real estate funds where the CIV is only

temporarily UK property-rich. In these cases, the fund will need to meet a genuine diversity of ownership or non-close test, and be targeting UK property investments of no more than 40% of fund gross asset value in accordance with its prospectus or other fund documents.

### The Transparency Election

**Which CIVs are eligible:** the following CIVs will be able to make a Transparency Election:

- the CIV must be non-UK resident, income tax transparent (eg a properly constituted JPUT or GPUT) and be UK property-rich;
- every investor in the CIV at the time the election is made must consent to the making of the election; and
- unlike the Exemption Election (see below), there is no diversity of ownership requirement.

Given the requirement for unanimous investor consent and the lack of the diverse ownership requirement applicable to the Exemption Election, **it is likely that more narrowly-held and joint venture CIVs, such as single property owning JPUTs and GPUTs, will make most use of the Transparency Election**, particularly where they have tax exempt investors.

**Timing and irrevocability:** a Transparency Election must be made within 12 months of 6 April 2019 for any existing CIVs (i.e. by 5 April 2020) or, for any CIV created after 6 April 2019, within 12 months of its first acquisition of UK property. No election can be made after these times. Note that a Transparency Election is irrevocable once made (even on a change in ownership of the CIV).

**Impact:** having made the Transparency Election the relevant CIV will be treated as transparent for purposes of NRCGT, so its investors (whether UK or non-UK resident) will be treated as if they had always owned an interest in the CIV's underlying property of the CIV and, if they are tax exempt in the UK, they will be able to benefit from the relevant exemptions. Any subsidiary entities below the CIV (including companies) are unaffected by the Transparency Election and would remain subject to NRCGT unless they can make a Transparency Election themselves – this needs to be borne in the mind in the context of structures in which CIVs (such as JPUTs and GPUTs) are "layered".

**On-going Filing Requirements:** having made the Transparency Election, a CIV will be required to file annual UK partnership returns disclosing details of disposals and investors.

### The Exemption Election

**Which CIVs are eligible:** the following CIVs will be able to make an Exemption Election:

- the CIV must be non-UK resident and must be UK property-rich;
- the CIV must meet a genuine diversity of ownership or 'non-close' requirement (which in certain cases will permit the CIV to be owned directly or indirectly by a small number of qualifying institutional investors and still be treated as 'non-close', and in some cases will require the CIV to have less than 25% of its investors in countries with double taxation treaties that remove the UK's taxing rights over gains;
- if the CIV is an AIF it will also need to be a CIV on another basis to be eligible, for example through being a CIS; and
- the Exemption Election may also be made by a non-resident (non-CIV) company owned at least 99% by a UK property rich CIV that is a partnership or a co-ownership authorised contractual scheme (CoACS) (ie made by an offshore company holding UK property on behalf of such a UK property rich CIV partnership or CoACS).

Unlike the Transparency Election, investor approval is not required, and the making of an Exemption Election is at the discretion of the manager of the CIV – this creates an important new decision point for managers of widely-held, UK property rich offshore funds: see below. Note also that there are complex provisions that apply to permanent or temporary breaches of the above qualifying conditions and where the value derived from underlying direct or indirect disposals of UK property by the relevant CIV is distributed in an income form to investors (other than certain qualifying institutional investors) rather than

being re-invested by the CIV, generally resulting in a "deemed sale and reacquisition" by relevant investors of their entire interest in the CIV at market value. UK tax advice should be taken in such circumstances.

**Timing and irrevocability:** An Exemption Election must be made with effect from 6 April 2019 or can be made at a later date with up to 12 months' retroactive effect. If an Exemption Election is made with effect from a date after 6 April 2019, details of any disposals by the CIV's investors in the previous two years (or since 6 April 2019, if later) must be provided to HMRC. Unlike a Transparency Election, an Exemption Election can be revoked at a later date.

**Impact:** Having made the Exemption Election, the relevant CIV will be treated as exempt from UK tax on direct and indirect disposals of UK property, and any entities owned by the CIV will also be exempt from UK tax on direct and indirect disposals of UK property (on a proportionate basis if such entities are not wholly owned by the CIV, provided the CIV directly or indirectly owns at least 40% of the underlying entity). NRCGT will only be applied (and calculated) on disposals at investor level so, where investors are tax exempt in the UK, they will be able to benefit from the relevant exemptions. Feeder companies into the CIV will also be exempt from NRCGT if they are wholly owned by certain qualifying institutional investors.

**On-going Filing Requirements:** The manager of the CIV will have to make annual filings with HMRC disclosing details of the CIV and its "group", any disposals by the CIV group, details of the CIV's investors and disposals or other capital transactions by the CIV's investors. For pre-existing CIVs established prior to 1 June 2019 there are dispensations in the information required where the manager is otherwise prevented from providing such information to HMRC for legal, regulatory or contractual reasons; this is a helpful saving provision, but emphasises a need for the constitutional documents for CIVs established after 1 June 2019 to contain provisions facilitating the filing of relevant information by the manager with HMRC.

### Decision-making dynamics around making an election

By way of reminder, if an offshore CIV eligible to make a Transparency Election or Exemption Election does not do so, it will be treated as opaque for gains purposes and therefore subject to NRCGT on its disposals (but remembering that the new legislation confirms that offshore CIVs that are partnerships will remain transparent for gains and will not, therefore, have to make such an election).

In the case of many (non-partnership) offshore CIVs, the making of an election will therefore have superficial appeal, as it essentially preserves the pre-April 2019 position of the CIV not suffering a direct charge to UK CGT.

However, since the outcome of making of an election will be the application of NRCGT at investor level rather than the level of the CIV, the question of whether the CIV's investors are (largely) tax exempt or not may have a bearing for the CIV's manager. Tax exempt investors will benefit from exemption at investor level and are likely to prefer an election to be made so there is no NRCGT charge at the level of the CIV. In some cases, depending on the timing of relevant disposals by the CIV and the value attributable to those disposals, non-tax exempt investors may prefer a charge to tax at the level of the CIV - would the proportionate NRCGT borne by the CIV on disposal be lower than the NRCGT suffered later and directly by the investor if an election had been made? That is a difficult call for any manager and can only be considered on a case-by-case basis.

Where a decision is taken to make an election, as flagged above, in some (but not all) cases, a sufficiently widely-held CIV may be able to make either form of election and face a choice in deciding which election to make.

Relevant factors might include:

- the fact that a Transparency Election requires unanimous investor consent (probably only possible for a more narrowly-held CIV to achieve), whereas an Exemption Election for a more widely-held CIV can be made at the discretion of the CIV's manager;
- the fact that a Transparency Election, once made, is irrevocable - an Exemption Election is not;

- the fact that a Transparency Election for an existing CIV must be made within 12 months of 6 April 2019 whereas an Exemption Election for an existing CIV must be made with effect from 6 April 2019 or can be made at a later date with up to 12 months' retroactive effect;
- the additional on-going filing requirements that attach to an Exemption Election; and
- the fact that subsidiary entities below a CIV can benefit from CGT exemption where their parental CIV makes an Exemption Election, but not where a Transparency Election is made, in which case they would have to consider making their own Transparency Election.

It is certainly clear that, in the run-up to April 2019, managers of relevant offshore CIVs considering an election will first have to determine whether their CIVs are eligible to make an election, and then liaise with their investors to determine whether an election should be made and, if either is available, decide which to make.

**For those forming new structures after 6 April 2019**, a Transparency Election is likely to be of most appeal to those establishing an income transparent structure, such as a property unit trust, with a small number of tax exempt investors. For those establishing a more widely-held structure with a mixture of exempt and non-exempt investors, forming an offshore fund that makes an Exemption Election or (see below) forming a UK REIT may be more suitable. Limited partnerships remain transparent for CGT purposes.

### A Level Playing Field for UK REITs (including Offshore Companies Structured as UK REITs)

The UK government has also announced consequential amendments to the UK REIT regime so as to create a level playing field as regards CGT between UK REITs (whether onshore or offshore) and those CIVs able to make an Exemption Election as described above. The UK REIT regime currently only provides a GCT exemption for direct property disposals and not for indirect disposals, such as share sales. From 6 April 2019 disposals of shares and other interests by UK REITs in the UK property-rich companies or deemed companies they own will become exempt from UK tax under the REIT rules.

### No On-shoring Imperative

The July 2018 consultation response from HMRC and HMT confirmed the proposed new measures are not intended to encourage on-shoring of structures to the UK, but simply to create a level playing field for offshore and UK investors. The final legislation described in this briefing very much confirms that intention to create a level-playing field as regards NRCGT treatment of offshore CIVs and REITs.

Whilst offshore structures (other than partnerships, electing CIVs and REITs) will, like their UK counterparts, become subject to NRCGT from April 2019, in light of (i) the ability of any non-resident UK property rich entities subject to the new NRCGT charge to rebase property values as at 5 April 2019; (ii) the movement of NRLs from the UK income tax regime to the UK corporate tax regime only from April 2020, and (iii) the anti-forestalling measures, back-dated to November 2017, which prevent avoidance by restructuring through double tax treaty jurisdictions, the rationales for sustaining the use of offshore structures to hold UK commercial property (which also include unparalleled legal and regulatory flexibility) hold good.

Non-UK resident companies will need to consider whether any changes to their structure are desirable in light of these changes. We have seen a few examples of such companies moving their tax residence (i.e. place of central management of control) to the UK (for example, by appointing directors already available to them in the UK) while maintaining their incorporation offshore. As opposed to a much more costly and time consuming restructuring exercise to move the companies onshore, this has the benefit of potentially reducing the ongoing administration costs and time involved in maintaining tax residence offshore while at the same time maintaining the other benefits an offshore company can bring, including greater legal and regulatory flexibility and potential stamp duty savings.

### Next Steps

We strongly encourage relevant managers, administrators and investors in relevant offshore structures to seek advice from their UK tax and regulatory advisors in the run-up to April 2019 as to the applicability of the new NRCG proposals to their structures and the processes for making the relevant UK elections, where applicable.

In the first instance, for managers this may involve an examination of the "property richness" of the relevant structure to check the new NRCG rules are applicable to it and, if so, to determine whether, having analysed the investor group and whether or not they are tax exempt, whether elections for the Transparency Election or Election Exemption, as applicable, are available and should be made. Discussions with the investor group may be advisable. An examination of the impact on all entities within a layered group structure is advisable, to see whether elections must be made for each entity or whether a form of group election might be available.

Where offshore entities and investors are likely to be subject to the new charge to NRCG from April 2019, the UK tax advice required is likely to include assistance in calculating the relevant gain (including analysis of the new rebasing rules) and preparing for UK tax reporting, UK tax returns and making tax payments.

### Where Can Mourant Assist?

Where JPUTs, GPUs and offshore funds are considering making a relevant election, Mourant can assist managers and managing trustees, for example in preparing the required investor consent documentation for Transparency Elections and checking the constitutional powers of managers of widely-held offshore funds to ensure they are authorised to make, and report under, an Exemption Election.

### Technical detail

The UK Finance (No.3) Bill published on 7 November 2018 (FB) can be found at <https://publications.parliament.uk/pa/bills/cbill/2017-2019/0282/18282.pdf>

This includes the legislation for NRCG measure at clause 13 and Schedule 1.

Schedule 1 contains a re-statement of Part 1 of Taxation of Chargeable Gains Act 1992 (TCGA), incorporating the core provisions of NRCG, and a new Schedule 1A to TCGA covers the rules on indirect disposals: both of these are broadly the same as the proposals published by HMRC and HMT on 6 July, but have been updated to reflect comments and feedback from the subsequent technical consultation stage. Part 2 of Schedule 1 to the FB also now includes the full consequential amendments. Paragraph 21 inserts a new Schedule 5AAA to TCGA, containing the specific funds provisions.

A Technical Note on Schedule 5AAA has been published here:

<https://www.gov.uk/government/publications/taxing-gains-made-by-non-residents-on-uk-immovable-property-in-collective-investment-schemes/taxing-gains-made-by-non-residents-on-uk-immovable-property-in-collective-investment-schemes>

There are also Explanatory Notes to the Bill, which can be found here:

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/754255/Finance\\_No\\_\\_3\\_\\_Bill\\_Explanatory\\_Notes.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/754255/Finance_No__3__Bill_Explanatory_Notes.pdf)

(see pages 27-45 for the Notes relevant to NRCG).

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