UPDATE

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Payment of UK CGT by non-UK residents on UK commercial property gains – relief for tax exempt investors and overseas funds.

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Summary

On 6 July 2018 HM Revenue & Customs (HMRC) and HM Treasury (HMT) published their response (the **Response**) to the feedback received from industry participants to their consultation document of 22 November 2017, in relation to the proposed imposition of a charge to UK CGT of gains on direct and indirect disposals of UK commercial property by non-UK residents from April 2019.

The Response can be found here:

https://www.gov.uk/government/consultations/taxing-gains-made-by-non-residents-on-uk-immovable-property

The related draft legislation, explanatory notes, and tax information and impact notes (TIIN) can be found here:

https://www.gov.uk/government/publications/capital-gains-tax-and-corporation-tax-on-uk-property-gains

Happily, the Response confirms that the government has taken on board concerns raised by respondents in relation to the potential for tax exempt investors and overseas funds to suffer an unfair tax outcome and offers proposals for further consultation in both of these areas.

Background

By way of reminder, the November 2017 consultation proposed the application of capital gains tax (CGT) to non-resident's gains 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, partnerships and unit trusts.

The stated rationales for the proposed changes are:

(a) to expand the tax base of both the corporation tax and CGT regimes, with additional revenue of £165m anticipated by 2022/23;

(b) to create a single, harmonised and simplified regime for disposals of interests in both residential and commercial property; and

(c) to 'level the playing field' as regards the application of CGT on disposals of interests in UK property to both UK residents and non-residents.

A number of industry participants (including the Jersey Funds Association and Jersey Finance Limited) had noted risks attached to that proposed policy, specifically:

- the risk to the UK that where, in the eyes of foreign and UK institutional investors, the proposals add elements of relative complexity and uncertainty to the UK CGT regime, those investors pivot towards other investment destinations in future, constraining foreign direct investment into the UK;

- the risk attached to a lack of clear and workable exemption system for a clearly defined class of tax-exempt investors; and
- the concern that the desired level playing-field between UK and non-UK investors will not be achieved if, as indicated by the initial proposals, overseas funds were to be treated prejudicially relative to certain UK funds (and the risk that this may also diminish overseas fund investment in the UK).

These risks and potential solutions were flagged in our February 2018 briefing, which can be found here:

https://www.mourant.com/news-and-views/updates/updates2018/taxing-gains-made-by-non-residents-on-uk-immovable-property.aspx

Proposals for tax exempt investors and overseas funds

Happily, the Response makes clear that HMRC and HMT have taken due note of the risks and concerns raised by industry, particularly as regards the possibility of tax exempt investors and overseas funds suffering an unfair tax outcome and offers relief in both of these areas. There was never any hope or expectation however that the timing of the proposals or the central principle of achieving a more level-playing field as between taxation of UK and non-UK residents would be subject to change.

The Response confirms that by far the largest area of focus in technical responses was on the treatment of collective investment vehicles, and of exempt investors such as pension schemes, with significant concern that investment in UK real estate would be impacted negatively if currently exempt investors were left exposed to tax at lower tiers of investment. Respondents also highlighted that investors in overseas collective investment vehicles were likely to suffer multiple tax charges on the same disposal due to the structures used and commercial practice in this area. It was also highlighted that exempt UK investors, such as UK pension funds, make significant investment in the UK real estate market through offshore funds, and would be impacted in the same way.

The two issues identified by the majority of technical responses as being of most importance were:

- the impact on exempt investors in offshore funds, where the rules as proposed could cause them to be taxed at the level of subsidiary holdings, and
- the potential for economic double taxation, due amongst other things to the indirect disposal rules, when disposals were made at a lower tier of a fund structure and the proceeds passed up to investors.

It was highlighted that it was normal for UK exempt investors, such as UK pension funds, to invest using offshore collective investment vehicles; not as a means of avoiding tax, but to retain their tax-free gains status when investing through subsidiary entities.

The government's core proposals as a means of responding to these industry concerns are as follows:

- transparent offshore funds (eg JPUTs, GPUTs or offshore limited partnerships) will be able to elect for transparency for the purpose of capital gains from the position of a non-UK resident investor (UK investors will retain their current treatment); and
- offshore funds that are not closely held, and which agree to reporting requirements, will be able to elect for a special tax treatment whereby gains by the fund or within its structure will not be taxable, but the investor will be taxed on disposals of their interest in the fund. This treatment would apply whether the fund was transparent or opaque.

The Response also acknowledges that there will be situations where exempt investors are involved in structures that do not fit within the definitions above but represent functionally the same intended outcome of joint investment (eg structures such as JPUTs and GPUTs which are not collective investment vehicles but are established for investment by tax exempt investors). The government recognises that other solutions will need to be considered in these situations.

Fund managers and promoters of overseas funds will therefore need to discuss with their UK tax advisers whether, having analysed their investor base (whether largely tax exempt or not), it will be more desirable for their transparent funds to make one of these elections, having regard to the impact on investors, the fund and potential purchasers of units/interests in the fund.

In conjunction with the fund election proposals described above, in relation to the 25%+ ownership test proposed to be applied to charging gains on indirect disposals, the Response recognises that its application to fund structures could cause significant potential problems for the funds industry and that

there is therefore a strong argument that such exemption is not necessary in the context of funds: those who invest in UK property funds know that they are investing in UK land and the government believes that they should be within the rules, even if this brings into charge some people who did not expect to be in scope of the changes based on the November 2017 consultation document. The government believes this change is in keeping with the overall aims of the policy and that it is fair to tax those who invest in UK land in this way.

Given the complexities of the issues at hand, there are no detailed legislative provisions accompanying the Response to enshrine these proposals for the treatment of overseas funds and tax exempt investors. Having signalled its proposed direction of travel, government instead intends for HMRC and HMT to continue discussions with stakeholders between now and the November 2018 budget, in the expectation that the final rules will be finalised for that budget and come into effect from April 2019. We welcome the opportunity for industry to engage in that process.

No "onshoring" imperative or facilitation

The Response confirms it is not the intention of the proposed measures to encourage on-shoring to the UK, but simply to create a level playing field for offshore and UK investors. As such, whilst HMRC and HMT acknowledge the calls from some respondents for a new type of more lightly regulated tax transparent UK fund vehicle to attract those currently investing through offshore structures to move their investments to the UK, the Response confirms (i) it is not being taken forward as part of this measure; and (ii) the application of SDLT seeding relief in onshoring scenarios is not appropriate in this situation, and the government has no plans to allow it as a part of this measure.

Technical detail

The Response does include draft legislation designed to implement the broader measures announced in November 2017, albeit tempered in some areas as described in the Response, including a re-write of Part 1 of the Taxation of Chargeable Gains Act 1992 (TCGA) so as to integrate the new rules more coherently, as well as consolidating changes made to Part 1 since it was first enacted in 1992.

Next steps

As described above, there will now be a period of further technical consultations on the legislation and proposals, particularly around treatment of overseas funds and tax exempt investors, with HMRC and HMT officials continuing to work closely with stakeholders to frame the final rules. The changes will be finalised for the November 2018 budget and come into effect from April 2019

As ever with complicated tax, the devil will come in the detail of the proposals and their workability in the context of real life structures, investors and advisors, but we and other industry participants will continue to work with HMRC and HMT in framing a workable solution.

Let us know...

If you have any thoughts or concerns on the practicalities of the proposals that you would like to share or discuss with us, please do let us know.

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