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'Taxing gains made by non-residents on UK immovable property' Some thoughts on the HMRC and HMT consultation

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Following the UK Budget on 22 November 2017, UK HM Revenue & Customs (HMRC) and HM Treasury (HMT) published a consultation document entitled 'Taxing gains made by non-residents on UK immovable property'. The central thrust of the proposals, to apply capital gains tax (CGT) to non-resident's gains on UK commercial property for the first time since the introduction of CGT in 1965, took the market by surprise, particularly in light of the April 2019 implementation date, just as Brexit takes effect.

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. This briefing looks at the rationales for the proposed changes, some key areas of concern and some potential solutions.

Responses to the consultation must be submitted by 16 February 2018.

The stated rationales for proposed changes appear benign:

(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,

but the proposals give rise to important considerations and areas of complexity and potential uncertainty for international investors in UK commercial property and infrastructure, whether investing through a simple holding vehicle, a joint venture or collective investment vehicle (**CIV**).

In this briefing we explore some of those considerations and the potential risks these changes pose to future foreign direct investment (**FDI**) in UK commercial property and infrastructure. We also explore ways in which HMRC and HMT, in framing the relevant legislation and guidance after their initial consultation period, might look to add clarity and certainty to minimise those risks.

The key areas of concern we have identified are:

- 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 FDI into the UK;
- the risk attached to a lack of clear and workable exemption system for a clearly defined class of tax-exempt investors (who often have a preference for investing through secure, tax neutral offshore vehicles);
- the risks to the UK of discouraging investment in UK commercial property through non-UK vehicles generally;

- the concern that the desired level playing-field will not be achieved if, as indicated by the initial proposals, overseas CIVs were to be treated prejudicially relative to certain UK CIVs (and the risk that this may also diminish overseas CIV investment in the UK); and
- although the political imperative is to target non-resident investors, the proposals effectively target non-domiciled investors, and that element of 'overkill' carries significant unrewarded risk to FDI into UK real estate and infrastructure – the proposals should take account of the fact that investors make domicile choices for varied reasons quite aside from tax certainty.

Below we look at each area in turn, offering some potential solutions that HMRC and HMT might consider.

Loss of FDI by adding uncertainty and complexity

The UK has long been a desirable destination for foreign direct investment in commercial property and infrastructure projects, particularly relative to other EU destinations. Recent property data showing net investment in UK property in 2017 provided by M&G Investments and collated by John Forbes Consulting LLC confirms that net investment in 2017 was dominated by overseas investors, with UK institutions confirmed as net sellers. Of those overseas investors, investors from the United States, China, Hong Kong and Singapore dominate. Much of that inward investment has been derived from tax-exempt qualifying investors such as sovereign wealth funds, pension funds, endowment funds and life assurance companies.

As offshore legal counsel, we have seen widespread use of offshore vehicles to hold UK commercial property and infrastructure assets, for a variety of reasons listed below, although the ability to invest through a tax neutral vehicle is crucially important for most tax-exempt investors. Our home jurisdictions have long acted as conduits for significant inward investment into the UK: in their recent report 'Jersey's Value to Britain' Capital Economics found that Jersey alone is a conduit for an estimated £½ trillion of foreign investment into the UK.

It is understandable that the UK might consider taxing gains related to that non-resident investment activity but the wider economic activity attached to this inward investment (including the related property and infrastructure development and construction activity funded by those same investors) and the risks of curtailing that activity need to be borne in mind, particularly in light of the relatively low levels of CGT anticipated to be raised relative to the amount of inward investment potentially at risk of diversion away from the UK.

The UK's appeal as an investment destination has been driven by strong fundamentals but also facilitated by the long-standing simplicity and certainty of the UK's benign CGT environment. In bringing forward these proposals, a means of taxing foreign gains should be found which minimises complexity, uncertainty and administrative burden particularly for tax-exempt institutions. The potential for negative impact will be exacerbated to the extent the new proposals create any risk of double taxation of non-resident investors at both a direct and indirect disposal level.

Evidence of the uncertainty already felt by existing UK real estate investors is apparent in the findings of a January 2018 Colman Parkes survey of 40 significant UK commercial property investors, with 65% predicting extra uncertainty well into 2020 and beyond, caused by the proposed extension of the UK tax regime, coupled with Brexit (see here).

Clarifying the following areas of complexity and/or uncertainty would be beneficial for non-resident investors:

- the 'property rich' definition (>75% of gross value) by addressing likely investor concerns over whether their investment is taxable, noting goodwill and intangibles are inherently hard to measure, which will create uncertainty around whether the 75% threshold is breached. There is also the risk that some non-UK gains could be taxed on non-UK residents;
- the 5 year 'look back' test could prejudice and dissuade seed investors in CIVs with large initial holdings – this issue might be resolved by application of a 'widely held' test – similar to that currently available within the UK's NRCGT rules;
- the 'acting together' rules and their potential impact on partners in an investment partnership or unit holders in a unit trust where deemed to be acting together simply because of a common investment policy or manager, or participating in the same CIV closing;

- double taxation and latent gains:- double taxation arises inherently from the imposition of direct and indirect charges and there is a specific risk of double taxation if a vendor makes a share sale disposal and pays tax on that gain but the base cost of the asset in the company remains low; and
- rebasing: the inconsistency in rebasing options between real estate assets and shares in property rich entities whereby assets can choose historic cost or April 2019 values, while for shares, there is only the option of applying the April 2019 value.

Need for 'look through' treatment of vehicles for tax-exempt investors

As well as being a popular destination for foreign tax-exempt investors, the UK has also been a popular destination for investment by UK resident but tax-exempt investors such as pension funds and life assurance companies. Whether UK or non-resident, all have contributed to the historically strong flows of capital towards UK commercial property and infrastructure development. Tax-exempt investors, whether UK- or non-resident, usually invest in property, whether or not situate in the UK, via a holding vehicle. Crucially this achieves ring-fencing of the underlying asset for the purpose of protecting their wider asset pool from liability risks, and can also facilitate onward sale to other tax-exempt investors and financing and related security arrangements.

Many tax-exempt investors also invest collectively in reliance on the expertise of asset managers (eg through CIVs), alongside other tax-exempt and non-tax-exempt investors. Some multi-managers, where they invest in UK real estate investment structures on behalf of underlying clients who are each small investors in their own right, have a practice of bundling together those investor interests when investing, for the sake of efficiency – there is a risk that smaller and/or tax-exempt investors will be brought within scope where multi managers invest (on a 'bundled' basis) on their behalf. Apportionment of gains and the related tax through the layers of an investment structure is laborious and administratively costly and, in the context of CIVs, may make it very difficult for exempt and non-exempt investors to continue to participate in the same CIV due to their varying cost expectations.

The consultation intends that those who are presently exempt or out of scope should remain so, but non-resident tax-exempt investors are likely to be discouraged from future investment in the UK, and UK tax-exempt investors and their funds may be subject to additional and unforeseen restructuring costs, if a direct charge on disposal is applied to any non-resident vehicle they invest through and 'look-through' treatment of the relevant vehicle (and any intermediate vehicles) cannot be achieved, such that they would fail to benefit from their expected exemption.

Potential solutions to this problem might involve (a) applying 'look-through' treatment to ensure overseas holding entities and CIVs are exempt from CGT to the extent that their investors are tax-exempt investors; (b) allowing an extension of the pre-existing Substantial Shareholdings Exemption (SSE) to holding entities and CIVs owned by tax exempt qualifying investors where making direct disposals of UK real estate; and/or (c) in the context of CIVs, applying a 'widely held' test – similar to that currently available within the UK NRCGT rules.

Risks attached to discouraging use of overseas structures

Although achieving tax neutrality is important to tax exempt investors, there are varied non-tax reasons why investors in UK commercial property, whether UK resident or non-resident, use offshore (and other overseas) structures and would choose to continue to do so even after the proposed application of CGT to UK property gains of non-residents. Offshore holding structures and CIVs offer the following features:

- a wide range of legal forms: – companies (including cellular variants), limited partnerships of various types, limited liability partnerships, trusts, unit trusts and foundations
- JPUTs and GPUTs offer income tax transparency on the basis of Baker Trust arrangements such that unit holders are taxed directly as recipients of income
- the security of the rule of UK law, with the UK Privy Council providing the ultimate court of appeal for Crown Dependency and Overseas Territory (CDOT) court judgments
- efficient mechanisms for the repatriation of capital to investors
- political stability and long-standing governmental support for the finance industry
- simple and stable systems of taxation, offering tax neutrality for cross-border investment without relying on complex or contrived DTA arrangements

- true centres of excellence for fund and holding vehicle administration, with strong UK real estate knowledge and expertise
- regulated administrators and company secretaries, with statutory obligations to adhere to the very highest global standards in anti-money laundering and anti-corruption regulations, beneficial ownership reporting and tax information sharing protocols (as recently assessed by MONEYVAL and the OECD) – as such, capital flowing through the CDOTs is 'clean capital' in a global context
- innovative regulatory models which combine appropriate (internationally assessed and approved) levels of regulatory supervision and oversight by local regulators, allied with swift and cost-effective licencing processes and appealing elements of structural flexibility (eg offering CIVs with closed ended and open ended variants and no leverage restrictions). EU Directives such as AIFMD do not have direct application absent any imperative to access the EEA market
- the offshore alternative funds sector has some years' experience of successful operation from third countries whose funds (AIFs) and managers (AIFMs) have been able to gain access to the EU professional investors market through national private placement whilst also marketing to non-EU investors without AIFMD restrictions – as the UK works through Brexit, there will remain some uncertainty over how its funds must be operated and can be marketed in the EU and the rest of the world.

We believe it would be beneficial to the UK to continue to facilitate the ability for onshore and overseas investment vehicles to be used for investment in UK commercial property and infrastructure projects, but to focus instead on finding fair and effective means of taxing overseas vehicles and their (non-tax-exempt) investors in respect of UK commercial property gains. The focus should be on the tax residence and not domicile of relevant investors.

Prejudicial treatment of overseas CIVs

The proposal in the consultation that direct disposals of UK commercial property by widely-held overseas CIVs should be chargeable to CGT, whereas direct disposals by UK CIVs (including REITs, PAIFs and EUUTs) would continue to be exempt, creates an un-level playing field, which unfairly prejudices overseas CIVs and their investors, and particularly any tax-exempt investors amongst their number (absent any specific 'look-through' exemption for those investors as described above). It is also contrary to the transparency principles for overseas mutual funds contained in existing UK legislation (specifically the Collective Investment Schemes and Offshore Funds (Amendment of the Taxation of Chargeable Gains Act 1992) Regulations 2017), which will require clarification.

A direct charge on overseas CIVs would:

- mean that the property richness and ownership threshold protections offered to UK CIV investors with small holdings would be denied to equivalent small investors in overseas CIVs;
- give rise to a CGT charge for tax-exempt investors in overseas CIVs (see above);
- reduce levels of overall CIV investment into UK commercial property and infrastructure, at least in the short to medium term, as UK CIVs have structural limitations relative to overseas CIVs; and
- encourage overseas CIVs to pivot their investment towards other countries, such as Germany, where they are offered equality of (transparent) treatment with domestic CIVs.

It appears from the consultation that HMRC and HMT fear a 'fault line' that could be exploited if overseas CIVs are not made subject to the direct charge, with concern about collection and enforcement of CGT on indirect disposals of interests in property rich overseas CIVs by non-resident (and non-exempt) investors. The tools available to HMRC in the context of tax collection from non-resident investors in UK CIVs (reliance on treaty provisions and the advisor reporting provisions in section 7 of the Consultation) are deemed insufficient in the context of overseas CIVs.

To avoid the downside risk to the UK attached to reduced overseas CIV investment, we have considered the following potential solutions:

Solution 1 – maintain transparency for overseas CIVs but create a UK CGT registration and agency regime

Allow property rich overseas CIVs to continue to enjoy the same transparent status as UK CIVs but alongside the creation of an overseas CIV registration and agency regime in relation to property rich overseas CIVs, to assist with the collection of CGT payable on indirect disposals by any non-resident and non-tax-exempt investors. Under this registration regime, property rich overseas CIVs would have an obligation to register with HMRC, and appoint a UK agent to represent their interests and assist in the collection of any CGT owed by the CIV's non-resident and non-tax-exempt investors. For so long as a property rich overseas CIV is owned entirely by tax-exempt investors, UK or non-resident, it should have no obligation to register. This solution would have echoes of the pre-existing UK Non-resident Landlords Scheme (**NRLS**). In the context of these transparent overseas CIVs, there would need to be an interpretation of the connected party test that counters abuse, allows small investors to enjoy the intended freedom from the indirect charge imposes a withholding tax but for larger investors on CIV redemptions, with an ability to claim a tax refund by tax-exempt investors.

Solution 2 – exemption for overseas CIVs with application of WHT

An alternative solution might involve overseas CIVs being permitted to obtain an exemption from the direct charge but instead apply a withholding tax deduction on redemptions with the possibility of reclaim of tax by any tax-exempt and/or small investors in the CIV. Here we note again that overseas landlords already deduct tax in some cases under the NRLS, so are familiar with this type of process.

Solution 3 –tax paid credits to overseas CIVs with tax-exempt investors

Alternatively, overseas CIVs might remain subject to the direct charge but with a tax paid credit that can then be passed through to any tax-exempt or smaller investors and reclaimed. In this scenario, the indirect charge would fall away to avoid the risk of double taxation.

Solutions 2 and 3 carry with them new levels of administrative complexity for investors who have not previously been required to make UK tax reclaim applications in the context of indirect investment in UK real estate (and amongst them tax-exempt and smaller investors generally not geared-up to making foreign tax reclaims), so solution 1 is likely to be preferred by them.

Overseas REITs – clarification needed

It is notable that a number of REITs have been established as offshore (eg Jersey or Guernsey) companies – to take advantage of features listed above – whilst then electing for UK tax residency and falling subject to the UK tax under the existing UK REIT rules. It will be helpful to have confirmation that overseas companies formed as REITs and operating in compliance with, and subject to UK tax under, the REIT rules (if and as amended) will continue to enjoy equivalent treatment to UK REITs, not least in the context of confirming the treatment of existing structures.

Risk of 'Overkill' – focus on residence, not domicile

The three stated objectives of the Consultation (revenue, simplicity and level playing field) can all be achieved by targeting residence, yet investor domicile choices appear to be under attack. As described above (see **Risks attached to discouraging use of overseas structures**) investors use non-UK-domiciled vehicles (often in offshore jurisdictions) for a variety of non-tax-related reasons. The consequences of preventing that practice do not appear to have been considered in the Consultation. The solution would be to make clear that there is no desire to affect investor domicile choices and recognise that investors might have non-CGT-related reasons for using non-UK vehicles. In support of that general message, it would be prudent to design the new regime so that, in appropriate cases, a non-domiciled structure (eg a JPUT or GPUT) could easily move its tax residency into the UK (eg by election) and thereafter fall within the direct charge to tax envisaged by the proposal.

Should you wish to express support for these or any other potential solutions or to flag these or any other areas requiring clarification, the consultation period for these proposals ends on 16 February 2018 and responses should be sent to: NRCG.Consultation@hmrc.gsi.gov.uk.

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