Analysis

# Extending CGT to non-resident investors in UK real estate: levelling the playing field?

## Speed read

**In the 2017 Autumn Budget, the government announced its intention to extend CGT to non-resident investors in UK real estate. The proposed measures mean almost all non-resident owners of UK land will be brought within the scope of UK tax on their gains, and a key tax benefit currently enjoyed by non-UK investors in real estate will be lost. The rules will also apply to certain disposals of interests in 'property rich' entities. It is proposed that the measures will apply to disposals from April 2019, but will only capture increases in value arising after this date. Those who are exempt from UK CGT will continue to be exempt under the new regime.**

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The government has announced that from April 2019 non-residents will be subject to UK tax on their gains arising from the disposal of UK real estate, bringing to an end a major advantage enjoyed by overseas investors. The change will align the UK with other major jurisdictions and is intended to level the playing field between domestic and non-resident investors. This article explains the key features of the measure and some of the issues arising from the proposals.

### Overview of changes

The long-established exclusion from CGT for non-residents had already been eroded by the introduction in 2015 of CGT for non-resident owners of residential property. Importantly, this regime included exemptions for widely held vehicles, as well as certain asset classes (e.g. student accommodation). Although many aspects of the new regime are subject to consultation, the government has emphasised that key features, including who is in scope, are fixed. The existing exemptions for widely held vehicles in the rules for residential disposals will be removed, so that almost all investors in UK land (both commercial and residential) will be subject to CGT. The government's intention is to align the treatment of resident and non-resident investors. In this context, the change is consistent with the extension of the corporate interest restriction to non-resident landlords from 2020.

Although the wholesale extension of CGT will be unwelcome and is likely to reduce the UK's attractiveness for overseas investors, one silver lining is the proposal to 'harmonise' the existing – often very complex – regimes for non-residents (including annual tax on enveloped dwelling (ATED) related CGT) with the new rules, so that going forwards there will be a single regime for non-residents.

The new rules go further than taxing direct disposals of UK land. They will also apply to certain disposals of interests in 'property rich' entities. A property rich entity is one that ultimately derives at least 75% of its gross asset value from UK real estate. Gains on a disposal will be chargeable where the person making the disposal holds (or has held in the last five years) a 25% or greater interest in the property rich entity. The indication is that in these cases the entire gain will be subject to CGT, not merely the proportion attributable to UK land.

The rules will apply to disposals from April 2019, but will only capture increases in value arising after this date. Rebasing to 2019 will be optional in the case of direct disposals, if this gives a worse result than using the asset's actual base cost. However, for indirect disposals rebasing to 2019 will be compulsory, the suggestion being that HMRC may find it hard to check computations of gains based on historic base costs where the asset in question is an interest in a vehicle.

The restriction of the new charge to gains arising post April 2019 will be welcome to investors whose assets are standing at a significant gain. However, there will nevertheless be concern that the date for rebasing could coincide with a dip in property values, coming as it does the month after the UK's departure from the EU.

The consultation is clear that those who are exempt from UK CGT (e.g. overseas pension funds) will continue to be exempt under the new regime. A major concern for exempt entities investing via real estate funds and joint venture vehicles will be that they are not in a worse tax position as a result of the changes than they would be if they held assets directly.

### Aggregating investors' interests for indirect disposals

Under the proposals, gains will be chargeable where the person making the disposal holds (or has held in the last five years) a 25% or greater interest in the property rich entity. Interests of connected parties are aggregated for these purposes, with the connected party test taken from CTA 2010 s 1122 and supplemented by the 'acting together' definition in the corporate interest restriction rules. This definition is very broad, and the government intends it to catch 'situations where persons come together as a group with a common object'. Hopefully, the government can be persuaded to tailor this part of the rules so that minority investors are not inadvertently brought within the charge. In particular, where a real estate fund is structured as a partnership, minority investors should not be treated as connected with each other simply by virtue of being partners. Guidance on when parties to joint venture and shareholder agreements are 'acting together' will also be important to avoid uncertainty for minority investors.

The five year look back will ensure that tax cannot be avoided by staggering disposals, but it could also penalise seed investors who have held more than 25% of a vehicle for only a brief period.

### Interaction with the substantial shareholdings exemption (SSE)

The relaxation of the SSE rules in F(No.2)A 2017 may mitigate the effect of the CGT extension for some investors. Generally, the SSE only applies to disposals of interests in trading companies, and so this will largely only be relevant for investors whose real estate assets are part of an operating business they own, obvious examples being hotel and care home groups. Following the changes last year, it does not matter if the investors are not themselves members of trading groups, so the SSE could apply to disposals of these assets which would not previously have qualified for the exemption.

The rules are further relaxed for disposals by companies owned by 'qualifying institutional investors' (QIIs) (including pension funds, charities and sovereign wealth funds). Such groups can benefit from the SSE even where the company being disposed of is not trading, as will be the case for companies holding let real estate with no operating business.

The expanded SSE will be useful for certain real estate investors; however, it has its limitations. In particular, it only applies to disposals by companies of shares in other companies. So it will not apply, for example, to disposals by a unit trust, or to direct asset disposals by QIIs. The government will be under pressure to extend the exemptions for QIIs within the SSE rules to all real estate disposals by non-resident QIIs.

### Potential for tax leakage and double charges in holding structures

A primary objective when structuring real estate funds and joint ventures is to ensure investors are not put in a worse tax position by investing in the fund than they would be in if they held the underlying assets directly. Historically, this has been achieved by using a mixture of transparent and non-resident entities as holding vehicles. CGT neutrality for exempt and non-resident investors can usually be managed by using non-resident or transparent vehicles (or a combination of the two). Provided the 'central management and control' of any opaque entities in the holding structure are located outside the UK, it should not matter how many holding vehicles are included in the structure, and it is common for funds to have multiple layers of holding entities (often these are included to provide flexibility to funders rather than for tax reasons). So, for example, a Jersey unit trust could be used as a fund vehicle, holding several subsidiaries and Jersey unit trusts, each of which holds a UK real estate asset.

This sort of multi-tiered structure could be inefficient under the new rules, with a single gain being taxed several times and exempt investors suffering tax leakage. In the example above, if the unit trust fund vehicle disposed of its units in a property unit trust, the gain on this disposal would be taxed. A further charge could arise on repatriation of the proceeds to the ultimate investors, if this is done by way of unit redemption or other capital disposal, as the fund unit trust will be property rich. It is doubtful whether the government will see this as an unfair consequence of the new rules, given that the same double charge would arise on a disposal by a UK company with UK shareholders. It is also unclear how the new regime will interact with recent changes to the CGT treatment of unit trusts that are transparent offshore funds.

Tax leakage can be avoided in some cases by structuring the sale as a disposal by the ultimate investors of their interests in the fund vehicle itself, which would result in a single tax charge for taxable investors and no tax for any exempt investors. However, this will not always be possible, particularly where there is more than one buyer for the fund's assets. Even where a disposal of the holding entity is possible, the price may be discounted to reflect the latent gain in the various vehicles, creating effective tax leakage for investors.

Another way to avoid multiple charges, and tax leakage for exempt investors, may be to hold assets through exempt vehicles such as real estate investment trusts (REITs), property authorised investment funds (PAIFs) and co-ownership authorised contractual schemes (ACSs). These will continue to be exempt from CGT under the new rules. However, disposals of interests in these vehicles by overseas investors will be caught, assuming the property richness and 25% tests are met. These vehicles are likely to become more popular following April 2019; however, they carry with them restrictive regulatory and tax requirements. In particular, the need for these vehicles to be open-ended (in the case of PAIFs and ACSs) and to satisfy genuine diversity of ownership conditions may make them ultimately incompatible with a number of investment strategies and unsuitable as joint venture vehicles.

### Double tax treaties

The proposals borrow certain elements and concepts from the transactions in UK land regime, including anti-avoidance measures designed to prevent 'treaty shopping'. The point here is that while most of the UK's double tax treaties reserve to the UK taxing rights on gains from disposals of property rich vehicles, not all do. In particular, the Luxembourg treaty does not allow the UK to tax such gains. Funds based in Luxembourg should be protected from the charge to the extent that they can structure sales as the disposal by Luxembourg vehicles of property holding entities (the treaty does not protect against direct disposals). That said, protection via the treaty could have a limited shelf life, as the government will be keen to amend it.

In addition, the anti-forestalling provision, introduced on Budget day with immediate effect, denies treaty relief where the main purpose of arrangements is to enjoy the benefits of a treaty. This should prevent the mass migration of funds from the Channel Islands to Luxembourg. Those in the process of setting up a fund in Luxembourg before the Budget may feel that non-tax related benefits associated with the jurisdiction mean that the anti-forestalling provision does not apply to them. Any argument that the anti-forestalling provision does not apply will be harder to run following the addition of a 'principal purpose test' to the treaty.

### Conclusion

The proposals mark a dramatic change to the CGT regime for non-UK investors, and are likely to lead to both significant reorganisation of existing structures and a fundamental change in approach when structuring new investments. ■

*The consultation document is available via bit.ly/2B1lvYk. Comments are invited by 6 February 2018.*

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- Non-UK resident landlords to be taxed on UK property gains (Elliot Weston, 10.1.18)
- Autumn Budget 2017: A to Z guide (23.11.17)