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UK to Tax Real Estate Capital Gains of Non-UK Investors

On 6 July 2018, the UK Government published draft legislation to extend the territorial scope of UK tax by bringing capital gains realised by non-UK resident investors from UK real estate within the scope of UK taxation with effect from 6 April 2019. Once enacted, the draft legislation will implement proposals first announced in November 2017. In some respects, the draft legislation provides greater clarity as well as some welcome relaxations from the original proposals, although certain areas (most notably the treatment of offshore property funds) have yet to be confirmed and remain the subject of ongoing consultation.

The New Capital Gains Tax (CGT) Charge

In summary, the new tax charge will apply as follows:

- *Direct sales*: direct sales of UK real estate will be subject to CGT;
- *Indirect sales*: CGT will also apply to sales of certain interests in so-called "property rich" vehicles;
- *Exemptions*: certain disposals will not be taxable—for example, if the disposal is made by a tax exempt entity or the "trading exemption" or the substantial shareholdings exemption applies to the disposal; and
- *CGT base cost*: in computing the capital gain, the acquisition cost for CGT purposes will be rebased to its market value as at 5 April 2019.

Interests in Property Rich Vehicles

Non-UK resident investors will be subject to CGT on the sale of interests in property rich entities which derive at least 75 percent of their gross asset value from UK real estate and in which the investor holds, or has within the last two years has held, at least a 25 percent investment. The stated purpose of the 25 percent threshold is to exclude small investors and instead to focus the CGT charge on investors who might be expected to have invested with an understanding of the entity's underlying asset portfolio.

The draft legislation provides further detail as to which rights and entitlements will count in testing whether a 25 percent investment is held and certain related matters, such as when the interests of persons connected with the investor should be aggregated with those of the investor for these purposes. One positive point to emerge from the legislation is that persons should not be regarded as connected simply by virtue of being partners in a partnership. A further concession made by HM Revenue & Customs (HMRC) following the public consultation process was to reduce the "look back" period for the 25 percent investment test from the originally proposed five years to two years.

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It is intended that investors who hold a 25 percent investment for only an insignificant period of time within the two-year period will be exempt from the new CGT. This ought to be useful for seed investors; however, "insignificant" is not defined in the legislation and further HMRC guidance will need to be provided in order for this to operate as a reliable exception.

Trading Exemption

The draft legislation envisages that an exemption will be available for direct or indirect disposals where the assets are used for the purposes of a qualifying trade to all be an insignificant degree. This exemption should be helpful in the context of investments in several sectors such as health care, hospitality and leisure, and retail. Again, HMRC's announcement of this exemption represents a positive outcome from the initial consultation process. HMRC will continue to consult on the scope of this exemption in order to ensure that it only applies where intended, so further refinement of this exemption should be expected. HMRC believes that this exemption should also assist in the context of infrastructure assets and does not intend to introduce a specific infrastructure exemption.

Rebasing

From the outset, these new rules have been intended to tax only capital gains arising after April 2019 and, accordingly, the legislation provides for a rebasing of UK real estate (direct disposal) or interest in a property rich entity (indirect disposal) to its market value as at 5 April 2019. Corporate investors, including unit trusts, will be subject to tax at the corporation tax rate (19 percent currently, declining to 17 percent in 2020). Individuals and other entities will be subject to CGT rates (currently 20 percent for higher and additional rate taxpayers for non-residential property).

HMRC has helpfully confirmed that non-UK companies which are "onshored" by becoming UK tax resident will retain the ability to calculate their gains or losses using the April 2019 rebasing.

It will be possible to elect out of rebasing and to return to the original base cost. This option could be attractive if the UK real estate has declined in value since acquisition, although a loss will not be capable of being set off against other gains where the original cost election is made on an indirect disposal.

Property Funds and Joint Ventures—Uncertainty Remains

Currently the draft legislation does not specify how the rules will apply to collective investment vehicles which invest in UK real estate. This is perhaps not surprising given the complexity of the issues involved, as highlighted by the range of representations made by interested parties during the consultation—for example, the need to mitigate the economic double taxation of the same underlying capital gain which could occur in the context of a multi-tiered offshore fund structure and the treatment of tax exempt investors in funds. In a pragmatic move, the UK Government has set out what it describes as a "high level framework" for the development of new rules for offshore funds and has stated its intention to work with the property investment industry in finalising the new rules. The UK Government's framework envisages that the principles summarised below will apply.

- Tax transparent offshore funds will default to being opaque for tax purposes unless they elect to be treated as transparent for UK income tax purposes, with the result that investors would then be treated as making a direct disposal of the underlying UK property. Tax transparent funds are also eligible for what the framework describes as "special tax treatment"—see below.
- Offshore funds which are widely held and agree to reporting requirements are expected to be eligible for special tax treatment which involves the offshore fund and any non-UK resident entities within its structure being exempt on any direct or indirect disposal gains. The corollary is that investors would be charged to tax on a disposal of interests in the fund, with the charge being calculated by reference to the value of their interests in the fund. The reporting requirements imposed on the fund are likely to include details of investors, disposals of interests by investors and the value of their interests.
- The UK Government has indicated that it will consider whether adjustments are required in order to address any disconnect between the value of the fund interests and the value of the underlying UK land.
- The UK Government will consider whether the imposition of a withholding tax on certain fund redemptions would be helpful in reducing tax administration in the context of smaller investors.

- There is currently no commitment to providing exemption for real estate joint ventures and other non-fund offshore entities where they include exempt investors, although the UK Government has undertaken to consult further on the possibility of making specific provision in this area.

Certain Non-UK Resident Investors Exempt

Certain non-UK resident investors, such as overseas pension funds and entities qualifying for sovereign immunity, should continue to be exempt from CGT on direct and indirect sales of UK land. In addition, following the expansion of the "substantial shareholding exemption", this exemption may allow certain disposals of property rich entities to be exempt from CGT in whole or in part.

Tax Treaties

Certain of the UK's double taxation treaties preclude the United Kingdom from taxing gains realised by non-UK tax residents on sales of interests in vehicles holding UK land. The current position is that a treaty eligible investor who is resident in one of these treaty jurisdictions (most notably, Luxembourg) could seek to rely on the applicable treaty to override the new rules and thereby exclude the new CGT charge on an indirect disposal. Therefore, the UK Government has publicly stated that it is in discussion with Luxembourg with a view to securing treaty amendments which would allow the new CGT charge to apply to an indirect sale. In addition, the new regime will include anti-avoidance measures which are designed to counteract attempts to restructure property holdings in a way that takes advantage of favourable tax treaties from 22 November 2017 (the date of the original announcement).

Advisors Not Required to Report

The original 2017 proposals had stated that third-party advisors (including accountants, solicitors and surveyors) would be required to report indirect sales of real estate through the sale of interest of property owning vehicles. However, following the consultation, the UK Government has announced that it will no longer be moving forward with this proposal.

Indirect Exits May Still Offer Advantages

Whilst the new CGT charge applies to both direct and indirect sales of real property by non-UK resident investors, some investors may be attracted to structuring their exit as a corporate vehicle sale on the basis that, as things stand, such a transaction would provide the buyer with a Stamp Duty Land Tax saving.

Next Steps

It is not expected that the core proposals will be modified significantly before they become effective. However, as the consultation process remains ongoing (especially in the context of property funds), there will be further developments in the coming weeks and months. Additionally, it is hoped that HMRC's published guidance will assist investors and advisers in assessing the scope and impact of the new package of measures.

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