The big read

Taxing non-residents on UK property gains: the rules for funds

Speed read

There is much for funds to be positive about in the latest draft of the rules taxing non-residents on gains from UK land. In particular, the transparency and exemption elections are included in roughly the form expected, and HMRC has clearly listened carefully to concerns raised by the industry. However, there remain a number of challenges, not least navigating the long and complex legislation applying the new rules to funds and their investors.

Emily Clark
Travers Smith
Emily Clark is a partner at Travers Smith who specialises in the taxation of asset managers and investment funds, acting for private equity houses, debt funds, infrastructure funds, venture capital funds and real estate funds. She advises on fund structuring, efficient remuneration arrangements and other tax issues affecting management houses. Email: emily.clark@traverssmith.com; tel: 020 7295 3393.

Jonathan Woodall
Travers Smith
Jonathan Woodall is a senior associate at Travers Smith who advises asset managers, investment funds and corporates on a wide variety of tax matters. He has a particular interest in all aspects of real estate taxation, including structuring property funds and the acquisition, development and disposal of a broad range of real estate assets. Email: jonathan.woodall@traverssmith.com; tel: 020 7295 3000.

As announced at Autumn Budget 2017, non-UK residents will from April 2019 be subject to UK tax on gains arising from disposals of all types of UK land and interests in UK property rich entities. This significantly expands the current non-resident capital gains tax (NRCGT) regime, which applies to UK residential property gains only and exempts (on claim) diversely held companies and widely marketed funds.

The draft legislation implementing this measure (and rewriting the existing NRCGT rules) was published in July 2018, but it did not contain any bespoke provisions for property funds. Instead, HMRC set out some high level proposals and acknowledged that further work was required in this area in light of issues raised during consultation.

In particular, respondents were concerned that funds would incur multiple tax charges in relation to the same disposal, and that exempt investors would end up bearing the economic cost of tax paid by funds in which they were invested.

After further informal consultation, the draft legislation for funds was published on 7 November 2018. It has generally been well received and many of the concerns raised during consultation have been addressed.

Nevertheless, perhaps unsurprisingly given the plethora of property fund structures for which it has to cater, the legislation is long (about 50 pages) and highly complex. So for those advising property funds and their investors, there remains a lot to think about.

Recap on the main rules

Unless an exemption applies, a non-resident will be subject to UK tax on gains arising from disposals made on or after 6 April 2019 of:

- interests in UK land; and
- interests in entities deriving at least 75% of their value from UK land (i.e. 'UK property rich' entities) where the investor has a 'substantial indirect interest' (SII) in that land.

The default rule is that an investor has an SII where it has a 25% plus investment in the UK property rich entity at any time in the two years prior to the disposal (unless for only an insignificant proportion of that period). The rationale for this threshold is that investors with a small interest in a company may not know whether or not it is UK property rich.

Unless a non-resident investor opts to retain its existing base cost, its interests in UK land (to the extent not already within the scope of the existing NRCGT regime) and UK property rich entities are rebased to April 2019 values. (This is likely to be a difficult time from a valuation perspective for obvious reasons, but a discussion of these challenges is beyond the scope of this article.)

There is an exception for disposals of interests in UK property rich entities that use their UK land for trading purposes, and the substantial shareholdings exemption (SSE) may apply where qualifying institutional investors (QIIs) are involved. Treaty relief may be available for residents of jurisdictions with treaties that do not give the UK taxing rights over gains made on disposals of UK property rich entities (e.g. Luxembourg). A targeted anti-avoidance rule (TAAR)/anti-forestalling rule seeks to prevent this feature being abused, and HMRC has said it will renegotiate such treaties.

Rules applicable to funds: the basics

The starting point in the new legislation for funds (which is set out in new Sch 5AAA to TCGA 1992) is to define the key gateway terms 'collective investment vehicle' (CIV) and 'offshore collective investment vehicle' (offshore CIV). See table A (opposite). Paragraph references are to Sch 5AAA.

As a result of the breadth of these definitions, Sch 5AAA will be relevant, at least to some extent, to almost all UK property holding structures (aside from straightforward corporate structures).

Offshore CIVs which are not companies or partnerships (so, most obviously, offshore unit trusts) default to being treated as companies for the purposes of the new rules (para 3). This ensures that all offshore CIVs (other than partnerships, which continue to be treated as tax transparent) are liable to corporation tax on disposals covered by the new rules.

The default position is then modified to take offshore CIVs and their holding vehicles out of charge (wholly or partly) where a transparency election or an exemption election is made. The bulk of Sch 5AAA is concerned with the operation of these exemptions, particularly the latter.

However, before considering these in detail, it is necessary to look at the other key provision, which 'switches off' the 25% SII threshold for disposals involving funds.

Indirect disposals: deemed SII

An investor disposing of an interest in a UK property rich entity is deemed to meet the SII test, regardless of the size of its holding, where the disposal has an 'appropriate connection to a CIV' (para 6). In addition to applying to direct disposals of interests in UK property rich CIVs (including UK REITs), an investor or a CIV is deemed to have an SII in a number of other scenarios. See examples at figure 1 (below).

Although the deemed SII rule will not be welcomed by investors, it was expected and would seem to be (at least in part) a reasonable quid pro quo for the exemption election (see below for details). However, it goes further in that it applies whether or not the CIV concerned has made such an election.

The main rationale for this appears to be that investors ought to know whether the property fund in which they are invested is UK property rich. But it is not clear that this will always be the case, in particular for real estate funds which invest in UK property but have a European or global strategy. So investors may still be left in the uncomfortable position of needing further information from the fund in order to determine their tax position – information that the manager in question may not be obliged (or willing) to provide.

Given that UK REITs will not be able to benefit from the exemption election (as they are onshore), investors in those entities which are UK property rich may be surprised to learn that they will also have a deemed SII regardless of the size of their stake. This is not as unfair as it might seem given that UK REITs are exempt from UK tax on property gains, and from April 2019 will generally be exempt from tax on gains from disposals of UK property rich vehicles too (para 114). But non-resident investors in UK REITs should take note nonetheless.

Having said all that, there is potentially some comfort for investors where the key CIV or CIVs (denoted by a '(Y)' in figure 1) is marketed as investing no more than 40% in UK land (the 'non-UK real estate' condition) *and* meets either the genuine diversity of ownership (GDO) condition; or, if the vehicle is a company (actual or deemed), it meets the non-close condition (see table B (overleaf) for details of these conditions).

Where these conditions are met, there will be no 'appropriate connection to a CIV' and sub-25% investors will be outside the charge (para 7). This will be helpful in situations in which non-UK focused funds inadvertently become temporarily UK property rich. However, funds may need to review the wording of their marketing materials to ensure that they give sufficient comfort to investors on this point. It will also be interesting to see whether the 40% threshold will affect funds' investment policies going forwards.

Overall, the deemed SII rule is of the utmost importance for taxpaying non-residents disposing of small interests in UK property rich vehicles, as it will essentially determine whether or not their disposal is within the scope of the new charge. Given the wide range of circumstances in which it applies, investors (and funds) will need to consider these rules for disposals made at any level of structure containing a CIV.

Transparency election

An offshore CIV which is:

- UK property rich (or is expected to be by reference to its prospectus); and
- transparent for income purposes (other than as a result of being a partnership),

may elect to be treated for TCGA purposes as a partnership (para 8).

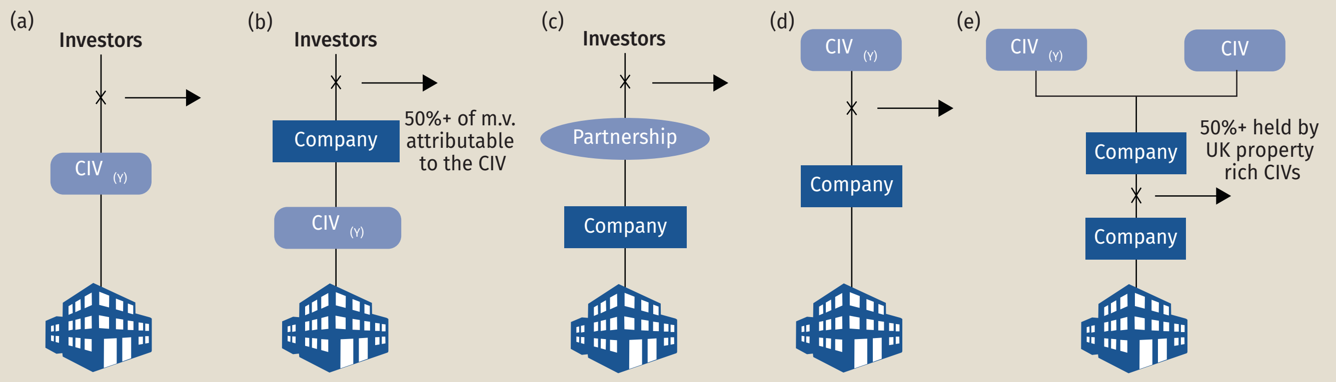
As a result of making the election, the CIV will not itself be taxed under the new rules. Instead, the investors (whether or not UK resident) will be treated as owning a share of the underlying assets and taxed according to their status on their share of any gains.

The election is aimed at situations in which exempt investors invest alongside taxable investors in income transparent closed-ended joint venture (JV) structures such

Table A: Gateway definitions

Term	Meaning
CIV (para 1)	1. Collective investment schemes, such as partnerships, property authorised investment funds (PAIFs), authorised unit trusts (AUTs), Jersey property unit trusts (JPUTs) and other offshore unit trusts; 2. Alternative investment funds (as per the Alternative Investment Fund Managers (AIFM) Regulations, SI 2013/1773, reg 3); 3. UK real estate investment trusts (REITs); and 4. non-UK companies which meet certain conditions. (This is intended to cover non-UK REIT equivalents, although arguably the net is thrown wider.)
Offshore CIV (para 2)	1. A CIV constituted as a body corporate (but not an LLP) resident outside the UK; 2. A CIV under which the property is held on trust for the participants where the trustees are non-UK resident (e.g., a JPUT); and 3. A CIV constituted by other arrangements that create rights in the nature of co-ownership where the arrangements take effect as a result of non-UK law. 'Co-ownership' is not restricted to the meaning of that term in the UK, and so (3) would include a non-UK partnership.

Figure 1: Appropriate connection to a CIV



(Y): key CIV or CIVs
Each of the disposals would have an 'appropriate connection' to a CIV with the result that the 25% SII threshold would not apply.

Table B: Key conditions

Condition	Requirements
Non-UK real estate condition (para 7(4))	A vehicle meets this condition if, by reference to the prospectus for the vehicle, no more than 40% of the expected market value of the vehicle's investments is intended to derive from UK land or interests in UK property rich companies.
GDO condition (paras 7(5) & 13(3))	A CIV or other vehicle meets this condition where it is 'widely marketed' as per the definition in the Offshore Funds (Tax) Regulations, SI 2009/3001, reg 75.
RSE condition (para 13(4))	A company meets this condition if it has ordinary share capital that is regularly traded on a recognised stock exchange.
Non-close condition (paras 7(6) & 13(5))	A company (actual or deemed) meets this condition if it is either: a. not close (under a modified version of the rules in CTA 2010 Part 2); or b. is close, but only because it has a qualifying investor as a direct or indirect participator. 'Qualifying investors' include limited partnerships, AUTs, REITS and PAIFs (provided they are themselves not close (if companies) or are widely marketed (if not companies)), as well as pension funds, insurance companies, charities and sovereigns. The net effect is that the non-close condition is met where qualifying investors own more than 50% of the company.
UK tax condition (para 13(7))	This condition is met in relation to a company (actual or deemed) where, on the assumption that all of the shares in the company were disposed of for market value, the person making the election considers that, as a result solely of double tax arrangements, no more than 25% of the total proceeds would fall to be left out of account for chargeable gains purposes. This is targeting situations in which investors may be able to rely on a double tax treaty to 'knock out' a charge on indirect disposals of UK land, e.g. Luxembourg resident investors.

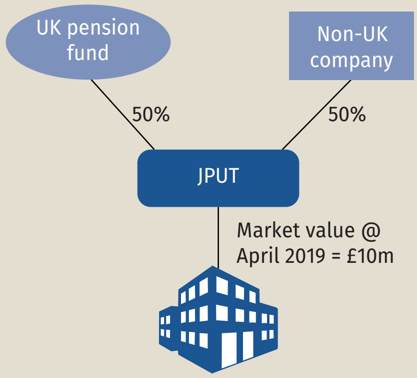
as JPUTs and other offshore unit trusts. By pushing the level of taxation up to investors, the election should ensure that each investor bears the right amount of tax in these types of scenarios.

Another helpful feature of the election is that there should not be any question of discounting the purchase price for latent gains in the underlying property where the units in an elected unit trust are sold. See the example at figure 2.

There are, however, some potential hurdles, and downsides, to electing:

- All current investors must have consented to the election when it is made, which may rule out more widely held CIVs.
- The election is irrevocable, which might be unattractive to some buyers (although note the point about latent gains above).
- The TMA 1970 provisions relevant to partnerships will apply, which will mean additional compliance burdens for managers (e.g. compiling and filing partnership returns and statements).
- UK resident investors will also be affected by the changes (and will need to adjust to their new-found partner status).

Figure 2: Transparency election



Asset sale	Unit sale
In December 2021, buyer purchases the property from the JPUT for £20m	In December 2021, buyer purchases the units from the unitholders for £20m
JPUT is treated as transparent so no CT charge arises at that level	JPUT is treated as transparent so no discount for latent gains required
UK pension fund is treated as making a £5m gain – no tax due to CGT exemption	UK pension fund makes a £5m gain – no tax due to CGT exemption
Non-UK company is treated as making a £5m gain – CT at 17% (£850k)	Non-UK company makes a £5m gain – CT at 17% (£850k)

Nevertheless, the transparency election will be cheered by UK pension funds and other exempt investors in close/JV structures. More widely held funds using JPUTs as holding vehicles may also wish to consider electing over these vehicles, although whether this is appropriate will depend on the circumstances.

Exemption election: the basics

Where certain conditions are met (see below), a fund manager may make an election to exempt a company (actual or deemed) offshore CIV (a 'qualifying fund'), or a company wholly owned by a partnership (a 'qualifying company'), from gains that would otherwise be taxable under the new rules (para 12). References below to a 'relevant fund' are to the qualifying fund or, in the case of a qualifying company, to the partnership which owns it.

The election also extends to entities in which the qualifying fund or qualifying company has an interest of at least 40% (para 16). Where the investment is less than 100%, gains are exempted proportionately to the level of investment.

A qualifying fund is any UK property rich offshore CIV which is a company (actual or deemed), provided that it fulfils one of the following criteria:

a. it is a non-UK CIS that meets the GDO condition (e.g. a widely marketed offshore unit trust);
b. it is a non-UK company (actual, not deemed) that meets the recognised stock exchange (RSE) condition and the non-close condition (e.g., a non-UK REIT equivalent); or
c. it is a CIV of any kind that meets the UK tax condition and the non-close condition (e.g. an offshore unit trust which is non-close and whose Luxembourg resident unitholders hold less than 25%).

A simple example is set out at figure 3. See table B for details of the conditions.

The exemption also applies where a partnership that owns (directly or indirectly) at least 99% of a UK property rich non-CIV company, wherever resident (i.e. the qualifying company), makes an election and either:

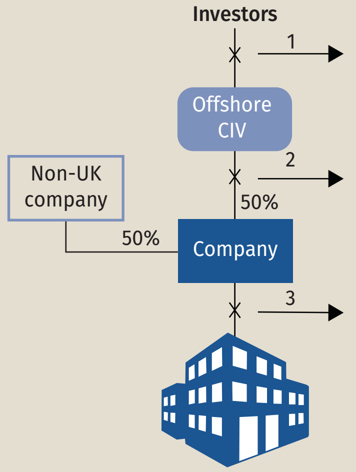
a. the company meets the UK tax condition and the non-close condition; or
b. the partnership meets the GDO condition.

An example of how this exemption applies is at figure 4. Note that the qualifying company exemption can apply to all-UK structures (unlike the qualifying fund exemption). There is also an equivalent exemption for companies owned by a co-ownership authorised contractual scheme (CoACS).

Where it applies, the exemption election will be crucial in ensuring that funds do not suffer one or more tax charges under the new rules, particularly in complex structures with several tiers of ownership. Fund managers will also no doubt be relieved that the deemed SII rules set out above apply whether or not an exemption election is made. Otherwise, they would have faced a potential conflict between investors above the 25% threshold (who would favour an election) and those below (who might not).

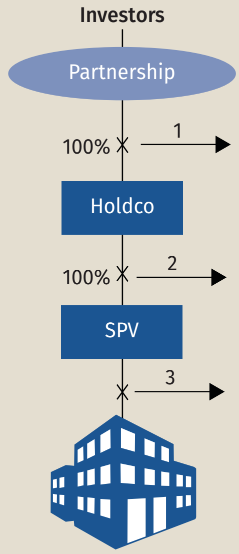
Exempt funds investing alongside taxable investors in JV companies that cannot benefit from the transparency election (e.g. a Jersey company), will need to consider how best to ensure that they get the full economic benefit of the partial exemption on a disposal by the JV company. This is likely to require bespoke provisions in the JV company's articles (see example at figure 3).

Figure 3: Exemption election (qualifying fund)



1. Investors taxed on gain according to their status
2. Offshore CIV exempt from CT on gain by virtue of election
3. Company exempt on 50% of gain by virtue of election – but non-UK company will indirectly benefit from this exemption (absent provisions to the contrary in company's articles)

Figure 4: Exemption election (qualifying company)



1. Non-resident investors taxed on gain according to their status
2. Holdco exempt from CT on gain by virtue of election
3. SPV exempt from CT on gain by virtue of election

Exemption election: other features

The (extensive) provisions relating to the exemption election contain a number of helpful additional features.

First, where a company (actual or deemed) is wholly owned by certain types of investors (broadly, investors which would themselves not be liable to tax on a gain by reason of exemption or immunity), it is exempted from tax on gains it makes from disposals of interests in a qualifying fund or qualifying company (para 33). This 'pass down' exemption should help prevent tax leakage in qualifying feeder funds.

Secondly, where a qualifying fund or qualifying company (or a subsidiary covered by the exemption) disposes of a wholly owned UK property rich company ('C'), C is deemed to have sold its UK land-related assets and reacquired them for market value (para 31). This base cost uplift should obviate the need for a discount to the sale price for latent gains on a share or unit disposal in straightforward cases. However, where the CIV holds less than 100% (but more than 40%), the rebasing is proportionate to the holding, which raises the prospect of partial latent gain discounts, and how to ensure that the exempt fund does not bear the economic cost.

Thirdly, where the exemption election has applied to a qualifying fund or qualifying company for at least five years, and subsequently:

- it ceases to apply (other than by reason of revocation by HMRC – see below); or
- the manager of the relevant fund takes steps to dispose of the fund's assets and wind it up,

the qualifying fund or qualifying company also gets a market value base cost uplift in its UK land-related assets (para 32). This ought to ensure that value accrued during the exemption period is not brought into charge later.

Exemption election: reporting conditions

In addition to the technical conditions outlined above, CIVs relying on the exemption election will need to meet annual reporting requirements. These are intended to assist HMRC in collecting tax due from non-residents.

Rather unsatisfactorily, the detail will be set out in HMRC guidance rather than legislation (see table C overleaf for a summary). More positive is the absence of a withholding obligation on fund managers (although there is a power for an elective regime to be introduced).

HMRC recognises that existing funds (or those established before 1 June 2019) may not permit managers to disclose some of this information and will accept that it is reasonable for them not to supply information to the extent this is the case.

This will be of some comfort to fund managers, but they will nevertheless need to review the information provisions in their fund documents to work out what information they can provide. It may also be necessary to negotiate amended terms for new funds.

Table C: Information reporting

Entity	Information
Relevant fund	Address, total value of disposals in the period and overall gains/ losses made.
Qualifying company/subsidiary entities covered by the exemption	As above, plus the percentage interest held by the relevant fund.
Investors	Address, unique taxpayer reference number (UTRs), total value of their disposals, gain/loss made (if calculable) and details of any exemption applying (if known).

Table D: Grace periods

Conditions	Consequences
30 day grace period for breaches that do not involve the qualifying fund or qualifying company ceasing to be UK property rich (para 27). This does not apply on more than four occasions in any 12 month period.	Breach of exemption conditions is ignored for all purposes.
The grace period applies where there is a breach of any condition which the manager expects to last for a temporary period of not more than nine months (para 28).	The exemption will continue to apply, but there will still be a deemed market value disposal for investors.
The grace period applies where there is a breach of any condition and the manager is taking steps with a view to the disposal of all the assets of the fund so that it can be wound up (para 30).	As above.

Exemption election: losing exempt status

Subject to a grace period applying (see table D), the exemption election ceases to have effect where the qualifying fund or qualifying company ceases to meet the key conditions (para 20). Aside from the loss of the exemption, the main consequence is that each investor is deemed to have sold and reacquired its units in the relevant fund at market value immediately before the condition is failed (para 22). Investors will be taxable on any gains treated as arising in accordance with their status (but potentially subject to deferral – see below).

A deemed market value disposal and reacquisition for a participant in a relevant fund also applies where:

- The participant receives proceeds in untaxed revenue (rather than capital) form that represent, in substance, value derived from an exempt disposal of UK land (para 21). This is to prevent returns from UK land escaping the UK tax net entirely; and
- A designated HMRC officer revokes the exemption election (either for a breach of the information provisions without reasonable excuse (para 15(5)) or where considered appropriate to safeguard the public revenue (para 18(1))) or the manager revokes the election (para 18(3)).

Generally, gains on deemed disposals are charged when the value is paid to the investors (e.g. on an actual disposal of units in the fund) or, if earlier, three years from the deemed disposal or when the fund is wound up (para 23). The main exception is when the election is revoked (whether by HMRC or the fund manager), in which case there is no deferral.

In certain circumstances (such as when the election is revoked or the three year deferral period ends), deemed disposals under these provisions must be notified to investors by the fund's manager in writing within 30 days (para 25) and there are penalties for non-compliance (para 26). Fund managers will need to have processes in place to be able to meet their notification obligations to investors, who in turn might want managers to agree to notify them in additional circumstances (e.g. when the election ceases to apply for reasons other than revocation).

Maintaining exempt status: general comments

It will be interesting to see how market practice develops in this area. Investors are likely to want assurances from managers that they will conduct the fund's business so as to maintain exempt status and will not revoke the election. Whether or not such assurances are given will depend on the relative bargaining strength of the parties.

But fund managers should be cautious about agreeing to anything too onerous because maintaining some of the exemption requirements is unlikely to be within their control. For example:

- a listed company might cease to meet the non-close condition as a result of share transactions in the market; and
- a fund could cease to be UK property rich if the value of its UK land assets fell as compared to its non-UK land holdings (and query how often a manager would need to test this – will relying on ordinary course valuations be sufficient for these purposes?).

Even where a manager does have some element of control, it might be unclear whether it should (or could) act to protect exempt status. For example, would the manager of a partnership owning a qualifying company be within its rights to refuse to register a secondary transaction involving a Luxembourg purchaser that would cause the UK tax condition to be failed?

There is also scope for the interests of exempt and taxable investors to diverge. For example, the sale of a sizeable UK asset might tip an exempt fund into being non-UK property rich. If the manager expects this to be temporary, the exemption will continue to apply but investors will make deemed market value disposals of their units. Exempt investors will be content with this, but taxable investors may not be.

This raises the prospect of the manager being in the uncomfortable position of needing to weigh investors' competing interests when making investment and disposal decisions, rather than simply having regard to ordinary commercial considerations. Fund managers may end up in a similar position when making investment decisions that tip their funds into being UK property rich for the first time.

So, while the legislation will have addressed the concerns of many funds that are clearly UK property rich, for those closer to the wire, the new rules are likely to have a material impact on their investment decisions and relations with investors. It may also be the case that pension funds and other exempt investors will start requesting that they are segregated in parallel vehicles (rather than 'mixing' with taxable investors) in order to avoid some of the potential complications referred to above. ■

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- The new regime for taxation of non-resident property gains (Peter Jackson & Harriet Revington, 14.11.18)