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INTERNATIONAL INVESTORS TO BE LIABLE TO UK TAX ON CAPITAL GAINS DERIVED FROM UK REAL ESTATE FROM 2019

To Our Clients and Friends:

Background

1.1 The UK has the largest commercial property market in Europe, attracting over $31bn of investment in the first half of 2017 (even after the Brexit vote). International investors dominate in London, lured by big buildings with long leases to established businesses and a stable legal environment - international investors account for about 75% of investment in property in central-London.

1.2 The UK traditionally had not taxed international investors on capital gains derived from investment in UK land and buildings. As such, the UK has long been a favoured destination for international real estate investors who have, year after year, consistently invested billions of dollars, euros, and pounds into both commercial and residential schemes. As compared with its peers, the UK has always been viewed as one of the most favourable real estate markets on the globe. The landscape may be about to change.

1.3 It has always taxed rental income (although with a generous deduction allowed for interest costs incurred on acquisition finance). Since 2013, the UK has imposed taxation on international investors on gains derived from some residential UK property, and these provisions were broadened in 2015.

1.4 The UK Government announced in the Autumn 2017 Budget (22 November 2017) that tax will be charged on gains made by international investors on disposals of all types of UK land and buildings – residential and commercial, and whether held owned directly or indirectly. The proposed changes extend the existing rules that apply to residential property and are due to come into effect from April 2019.

1.5 The UK Government has published a consultation document ("Consultation Document")[1] on the implementation of the new taxation regime. The Consultation Document proposes that a single regime will be created for the disposal of interests in both residential and non-residential property.

1.6 The proposed rules are intended to apply not only to direct disposals of UK immovable property, but also to indirect disposals – in other words the sale of interests in entities whose value is derived from UK land and buildings.

1.7 Anti-forestalling measures will be introduced with effect from 22 November 2017 (being the day on which the announcement was made), to prevent circumvention of the tax through "treaty shopping".

Autumn Budget 2017 Consultation Document

2.1 The Consultation Document makes it clear that the UK Government's policy is to amend the law with effect from April 2019 to bring non-UK residents within the charge to UK tax on disposals of all kinds of UK immoveable property, more closely aligning the tax treatment of non-UK residents with that of UK residents, and reducing the incentive for multinational groups to hold UK land and buildings through offshore structures.

2.2 The consultation being conducted relates to the implementation of this policy, not to its principle. In the current political climate in the UK, our view is that it is highly likely that the proposals in the Consultation Document will be implemented.

Direct disposals

3.1 The UK Government intends that all gains accruing on disposals of interests in UK immovable property will become chargeable to UK tax with effect from April 2019.

3.2 Non-residents will be taxed on any gains made on the direct disposal of UK land and buildings. In addition, disposals by non-resident widely-held companies will be brought into charge to tax.

3.3 The rate of tax on any direct disposals will be the UK capital gains tax (subject to the move to corporation tax for corporate owners – see below).

3.4 Non-residential property already owned as at April 2019 will be re-based to its April 2019 value – with the intention that non-residential property will only be taxed to the extent of its appreciation in value after April 2019.

3.5 Gains arising on the disposal of residential property are already within the scope of UK tax, and the re-basing point for residential property will remain at April 2015. In cases of mixed-use property (where the property includes both residential and non-residential elements), or in the case of change of use (for example, the conversion of residential property to non-residential use, or vice versa in the period between April 2015 and April 2019), there will need to be an allocation of the gain between the different elements, using the different rebasing points.

3.6 The NRCGT regime currently excludes widely-held companies from the scope of tax. That exemption will be removed with effect from April 2019.

3.7 Gains will be computed in the same way as for UK resident investors. Any losses arising on the disposal of UK property will be available for offset against UK taxable gains. For companies within the scope of corporation tax, the losses will be treated in the same way as other capital gains and losses for

corporation tax purposes. For other investors, capital losses will be available for offset against capital gains arising on the disposal of other UK property.

3.8 Owners who are exempt from UK tax, otherwise than because of their non-resident status (such as certain pension schemes or sovereign investors), will be exempt from the tax.

3.9 If the property owner has made an overall loss on a direct disposal of the property, but re-basing results in a taxable gain, there will be an option for the loss to be computed using the original acquisition cost.

Indirect disposals

4.1 Disposals of significant interests in entities that own (directly or indirectly) interests in UK real estate will also be brought within the scope of UK tax.

4.2 The following tests must be met at the date of disposal in order for a tax charge to be imposed:

4.2.1 The entity being disposed must be "property rich"; and

4.2.2 The non-resident must hold a 25% or greater interest in the entity, or have held 25% or more at some point in the five years ending on that date

4.3 Property Rich: An entity is "property rich", if 75% or more of its gross asset value as at the time of the disposal is derived from UK immovable property. This includes any shareholding in a company deriving its value directly and indirectly from the UK property, any partnership interests, any interest in settled property as well as any option, consent or embargo affecting the disposition of the UK property. The test looks through layers of ownership to arrive at a just and reasonable attribution of value. The value of both residential and non-residential UK properties will count towards the 75%. However, the value of non-UK property will not count towards the 75%.

4.4 The property richness test is applied to the gross value of the entity's assets, so liabilities such as acquisition finance are excluded in making the assessment. The test uses the market value of the assets of the entity at the time of the disposal.

4.5 If an entity is not property rich at the time the investor acquires his investment, but becomes property rich subsequently, the whole of the gain is within the scope of UK tax – not just the amount attributable to the period after the company becomes property rich (subject to April 2019 rebasing). Rebasing to April 2019 is the only calculation permitted for investments held prior to that date (the ability to use original acquisition cost is not permitted for indirect disposals).

4.6 25% Ownership: The 25% ownership test is intended to exclude minority investors who may not necessarily be aware of the underlying asset mix of the entity, and who are unlikely to have control or influence over the entity's activities.

4.7 In determining whether an owner has a 25% interest, the owner will need to look back over five years to see if the test was met at any time in the five-year period. In addition, holdings of related parties will also be taken into account in the determination. For these purposes, related parties will include persons who are "connected" (using the existing rules in the UK Corporation Tax Act) but also persons "acting together", to include situations where persons come together with a common object in relation to a UK property owning entity. The "acting together" rules will be modelled on those in the UK's corporate interest restriction provisions.

4.8 Although the tax charge will be limited to gains accruing after April 2019 (because of the re-basing), the "look back" would take account of holdings of the owner prior to April 2019 (if that falls within the 5 year look-back period). So an investor who currently owns 50% of a UK property investment company, but sells down to 24% before April 2019, would not avoid the new tax charge if she or he sold the remaining holding before 2024 (the tax charge would be limited to the appreciation of the value of the 24% stake, and would be re-based to April 2019 values).

4.9 Groups: The property richness test will be applied to the totality of entities being sold in a transaction. So if an investor were to sell shares in a holding company which was not itself property-rich, but which owned entities that were, the 75% test would be satisfied if, taken together, the entities being sold met the 75% test.

4.10 Calculation of gain: Gains will be calculated on the basis of the interest being sold, using the normal rules that apply to the disposal of shares (or other investments). Anti-avoidance provisions will apply in the same way as they would to UK resident taxpayers. Investors who are exempt from UK tax, otherwise than because of their non-resident status (such as certain pension schemes), will be exempt from the tax.

4.11 Substantial shareholder exemption: The Finance (No 2) Act 2017 introduced changes to the substantial shareholder exemption ("SSE") to extend the exemption to qualifying institutional investors. SSE will apply to disposals of property rich companies (or groups) by such investors.

Residential property

5.1 The current NRCGT rules apply only to direct disposals, and do not apply to disposals by widely-held companies.

5.2 NRCGT will be amended so that it extends to widely-held companies, and also to bring indirect disposals within the scope of the tax. The exemption within NRCGT for life-assurance companies owning residential properties will also be removed.

5.3 Widely-held companies will use April 2019 as the NRCGT rebasing point for all property disposals (both residential and non-residential). Closely-held companies will continue to use April 2015 as the rebasing point for direct disposals of residential property (and will use April 2019 for disposals of non-residential property).

5.4 April 2019 will be the NRCGT rebasing point for all disposals of indirect interests.

5.5 The NRCGT rules will extend to widely held companies whereby any disposals of UK residential property will be charged to corporation tax. Non-resident close companies disposing of residential property will also be charged corporation tax instead of capital gains tax.

5.6 The UK Government is considering harmonising the existing regime for ATED-related gains with the wider proposals for taxing non-resident gains on UK immovable property, and one of the areas of consultation within the Consultation Document relates to the simplification and harmonisation of the ATED rules.

Double Tax Treaties

6.1 It is generally accepted that the primary taxing rights over immoveable property (such as land and buildings) belongs to the state in which the immovable property is located.

6.2 As historically the UK has not exercised this right, it has not been concerned to ensure that this right is fully reflected in its double tax treaties. A number of treaties will require amendment to give the UK full taxing rights in relation to indirect disposals. In the meantime, the impact of a particular treaty may be to exempt from UK tax a disposal of an indirect interest in UK land and buildings – this is subject to the anti-forestalling provisions described below.

6.3 All of the UK's double tax treaties include a provision allowing the UK to impose tax on a direct disposal of UK immoveable property.

6.4 Most (but not all) of the UK's tax treaties include a "securitised land" provision, which allows the UK to impose tax on gains on the disposal of interests in entities that are UK-property rich.

6.5 But some older treaties do not include a securitised land provision, and these allocate taxing rights on the disposal of interests in a UK-property rich entity to the country of residence of the investor, and not the UK. Even where a treaty includes a securitised land provision, some apply only to shares in companies, and not to interests in other entities (such as partnerships or unit trusts), and in some of the treaties, the securitised land provisions apply only to the disposal by the investor of the interest it holds in the entity, and would not apply to disposals by underlying entities. In these cases, the UK's taxing rights will be limited.

6.6 In cases where no tax treaty exists, the UK will be able to apply the indirect disposal charge without constraint.

6.7 Where a doubt tax treaty does exist, but does not allow the UK to tax indirect disposals without constraint, the UK government has announced its intention to negotiate with the other state to amend the treaty. Subject to the anti-forestalling provisions, if a non-resident investor disposes of his interest in a UK-property rich entity prior to the amendment taking effect, then the investor may be able to benefit from any exemption from UK tax in the treaty.

6.8 However, an anti-forestalling rule will apply to prevent investors from being able to reorganise their affairs in order to take advantage of a treaty exemption to which they are not already entitled. The

anti-forestalling rule will apply to any arrangements entered into or after 22 November 2017 with the intention of obtaining a tax advantage relating to these new tax provisions through the operation of the provisions of a double tax treaty exemption. In these circumstances, HMRC will have the power to counteract the tax advantage by means of a tax assessment or the disallowance of a claim.

Collective Investment Vehicles

7.1 UK REITs: The profits and gains of the property rental business of a UK REIT are exempt from tax, and there is no intention to change this rule. A UK REIT is required to distribute at least 90% of its rental income by way of dividend, which is then taxed in the hands of its shareholders. There is no requirement for a UK REIT to distribute capital gains, but if those gains are distributed by way of dividend, those dividends will also be taxable in the hands of shareholders.

7.2 Currently UK residents shareholders are taxed on gains realised on the disposal of shares in a UK REIT, whereas non-resident shareholders are not. Under the new rules, if a UK REIT satisfies the property richness test, then a non-resident disposing of shares in the UK REIT will be within the scope of UK tax (if the non-resident has a 25% or greater interest in the REIT at the time of disposal or in the prior 5 years).

7.3 The intention is that a similar analysis would apply to other UK collective investment vehicles (such as property authorised investment funds and exempt unauthorised unit trusts), and the vehicle itself would not be liable to tax on the direct disposal of UK property. However, a non-resident investor would be liable to UK tax on a disposal of its investment in the vehicle (assuming the vehicle was "property rich" and the investor's interest exceeded 25% (at the time of disposal or in the prior five years).

7.4 Overseas collective investment vehicles: Some funds are outside the scope of UK tax on capital gains only because of their non-resident status. This will change with the new rules. Direct disposals by such collective vehicles will come within the scope of UK tax with effect from April 2019. And from that same date, disposals by investors of their interests in such vehicles will also become taxable (assuming the vehicle was "property rich" and the investor's interest exceeded 25% (at the time of disposal or in the prior five years).

Corporation tax

8.1 In March 2017, the UK Government published its consultation on "Non-resident companies chargeable to Income Tax and Non-resident CGT", which sought views on bringing closely held companies that own UK property within the scope of UK corporation tax.

8.2 A response to that consultation is expected to be published shortly, but the indication is that non-UK resident companies that own UK property will be brought within the scope of UK corporation tax as regards their UK property business.

8.3 The move to the corporation tax regime will have the effect of reducing the headline tax rate for such companies. The Government has announced that the main corporation tax rate will be 19% for the financial years 2018 and 2019, and will reduce to 17% for the financial year 2020.

8.4 In addition, the regime for tax reliefs for financing costs is somewhat more flexible under corporation tax rules than under income tax rules, and technical issues that can arise when a property is refinanced should no longer apply.

8.5 However, companies within the scope of corporation tax are subject to interest restrictions (broadly 30% of consolidated "tax EBITDA" with a de minimis of £2 million), and to the ability to carry-forward losses. There are limited exceptions for public infrastructure projects. These rules are complicated and outside the scope of this alert as are the application of the hybrid entity rules and the carry-forward loss limitations, which will also become applicable.

Administration and compliance

9.1 Non-resident direct owners of UK property are already within the scope of UK tax (at least as regards rental income) and will be filing UK tax returns in respect of rental income under the Non-Resident Landlord Scheme. However, investors in property-rich entities will not be used to filing UK tax returns.

9.2 HMRC anticipate that most persons within the scope of the new charge will be aware of their obligations to file UK tax returns and pay UK tax, and will be compliant. But in order to ensure that HMRC are aware of transactions, reporting obligations will be imposed on professional advisors, as described below.

9.3 Under the current NRCGT 9.3 regime, a transaction must be reported by the seller to HMRC electronically within 30 days of completion. If the seller is already within the self-assessment regime, they may defer payment of the tax until the tax is due under the normal reporting process. Otherwise, they must pay within 30 days. The same process will apply to the new charge for investors who are not within the scope of corporation tax. This will apply to direct and indirect disposals, and for residential and non-residential properties.

9.4 For companies within the charge to corporation tax, they will be required to register for self-assessment with HMRC, and return (and pay) any tax within the normal corporation tax self-assessment process.

9.5 So that HMRC will become aware of indirect disposals, reporting obligations will be imposed on advisors who meet the following conditions:

9.5.1 The advisor is based in the UK;

9.5.2 The advisor is paid a fee for advice or services relating to a transaction within the new rules;

9.5.3 The advisor has reason to believe that a contract has been concluded for a disposal falling within the new regime;

9.5.4 The advisor cannot reasonably satisfy themselves that the transaction has been reported to HMRC.

9.6 The time limit for the advisor is 60 days – which should allow time for the non-resident to report the transaction himself, and show an official receipt for its report to its advisor.

9.7 HMRC will have powers to recover unpaid tax from a UK representative of a non-resident investor and from related companies. 9.8 Penalties and interest charges will be imposed for compliance failures.

Conclusions

10.1 In some respects, the move by the UK Government to impose tax on foreign investors in UK real estate should come as no surprise. In a time of austerity, raising tax receipts is an important part of the public finances, and seeking tax from overseas investors (who have no vote) is an obvious target.

10.2 Imposing capital gains tax on international investors in real estate brings the UK in line with most other jurisdictions.

10.3 At the moment, all we have is a consultation document. The Government has stated that it will publish its response to the consultation in Summer 2018, together with draft legislation. The actual legislation will be introduced with the Finance Bill in April 2019, to take effect from April 2019. Until we have sight of the draft legislation, it is difficult to provide anything other than a high level overview of the proposals.

10.4 However, there are some immediate thoughts that come to mind.

10.5 First, consideration should be given to the timing of capital expenditure. If an amount to be spent on capex will not be immediately reflected in the value of the building, consideration should be given to deferring the expenditure until after April 2019. This is so the full amount of the expenditure is treated as "enhancement" expenditure for base cost purposes, rather than getting lost in the rebasing valuation as at April 2019.

10.6 Second, if property is currently owned through a company incorporated and resident in a country with a favourable tax treaty with the UK, disposals of interests in such company may be exempted from the new indirect disposal charge under the terms of the treaty (which under UK general tax rules will trump domestic law), at least until such time as the UK and the other jurisdiction amend the treaty (and, unless the new multilateral instrument process can be utilised, the process of amending tax treaties is rarely rapid). To the extent that such structures can be kept in place without changes, they should.

10.7 However, the anti-forestalling provisions will counteract any attempt to redomicile a structure that does not already benefit from treaty reliefs into a favourable treaty jurisdiction. Quite how the anti-forestalling provisions will apply is not stated in HMRC's technical note, and may be challenging to implement without the consent of the other jurisdiction involved.

10.8 Third, international investors, who benefit from UK tax exemptions (otherwise than because of their non-resident status), may want to restructure their ownership arrangements in order to benefit from their tax-exempt status, particularly if they own UK property through special purpose vehicles resident

outside the UK.. This could be of particular relevance to overseas pension funds and sovereign investors, who would not be liable to UK tax if they hold property directly (or through fiscally transparent entities). Any restructuring may need to be put into place before April 2019 to ensure that the restructuring does not itself trigger a tax charge under the new regime.

10.9 Fourth, the structure of the proposed arrangements can give rise to the possibility of tax being charged at multiple levels where property is held by an international property investment funds through SPVs. Depending upon the proportion of UK and non-UK properties held by the fund, charges could arise on the disposal of individual SPVs (owning UK properties) and on the disposal by investors in their holding in the fund. Staging and timing of disposals may be important to mitigate the impact of potential double tax charges, so that at the point at which investors realise their holding in the fund, it is no longer "property rich".

10.10 Fifth, The use of tax efficient onshore-UK structures (such as UK REITs, PAIFs and ACSs), is likely to become more prevalent, if only to restrict any tax charge to just one layer, and not at multiple levels. However, the Consultation Document does state that the Government will be considering whether changes to these regimes will be required to prevent tax avoidance.

10.11 Sixth, the interaction between these new provisions and the Substantial Shareholder Exemption is not entirely clear from the Consultation Document. Whilst the application of SSE to Qualifying Institutional Investors is clearly preserved, it is unclear whether SSE would be available for disposals that would otherwise qualify for the SSE. This is of particular importance to active trading businesses (such as hotels and care homes) that have a significant property component to their overall valuation. In the case of OpCo-PropCo structures, depending upon how the provisions are legislated, there might be benefits in migrating PropCos into the UK so that they clearly qualify for SSE on a disposal of the entire business.

10.12 Finally, challenges will also bring opportunities. Although some investors may find that their after-tax return from UK property investment will be diminished as a result of these changes, investors who are already within the scope of UK tax (or exempt from tax) will be no worse off as a result of these changes, and may find opportunities for investment. It would be no surprise if the spectre of this legislation brings into play "price chip" discussions as cash-rich investors seek to capitalise on uncertainties that inevitably will feature in the minds of sellers.

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[1] *See* HM Treasury and HM Revenue & Custom Autumn Budget 2017 - Open Consultation on Taxing gains made by non-residents on UK immovable property (22 November 2017), *available at*https://www.gov.uk/government/consultations/taxing-gains-made-by-non-residents-on-uk-immovable-property

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