GIBSON DUNN

December 17, 2018

UK REAL ESTATE TAX – A NEW LANDSCAPE FOR INVESTORS

To Our Clients and Friends:

This is an interesting time to be a UK citizen, not least because of the unpredictable political situation. However, UK tax policy regarding real estate investment and taxation of real estate structures has been a moving target since before the Brexit referendum. Whether to raise more revenue from the sector or to rectify existing gaps in the legislation, the regular changes to the UK tax rules on real estate indicate confusion amongst policy makers on the best approach. One could credibly accuse HMT and HMRC of reacting piecemeal to issues and not offering a coherent policy which provides certainty and predictability to the sector. Inbound investment is crucial to the present (and future) of the UK economy and the industry is stressing these points to the Government, despite their attention being elsewhere.

How we got here

Historically, the United Kingdom has always sought to tax non-residents on income which has a UK "source", such as rent payable on land and buildings in the UK (albeit with deductions for associated revenue expenses, such as interest incurred on related finance). But it has not taxed capital gains realised by non-UK residents in respect of the underlying UK asset. There were exceptions, for example in cases where the land and buildings were held as dealing stock (including as part of a property development business), or where the building was used by the owner as part of the owner's own operating business (such as a hotel owned by a hotel business).

This changed in 2013 with the introduction of the annual tax on enveloped dwellings (ATED), and ATED-related capital gains tax was charged on disposals of "enveloped" residential property. Non-resident capital gains tax (NRCGT) was introduced in 2015 for disposals of closely-owned residential property not caught by the ATED rules.

In 2016, the scope of the UK "transactions in land" rules were amended to capture a broader range of profits ultimately derived from property development and dealing in the UK where these had previously fallen outside the scope of the "dealing stock" charge. And there were further refinements to VAT and capital allowances rules impacting the sector, not to mention a wholesale restructuring of the way stamp duty land tax (SDLT) was assessed on property transactions.

The Government published a consultative paper in November 2017 proposing that non-resident investors in UK real estate should be brought within the scope of UK tax with effect from April 2019, and draft legislation was published in July 2018. These proposals were modified in the Government's Budget announcement in November 2018, and a Finance Bill embodying these final proposals is currently before Parliament.

This alert reviews the state of the legislation currently before Parliament and summarises the principal changes made since our previous alert. This also includes changes announced in the Budget of which there was no prior notice, which impact the taxation of real estate beyond capital gains.

The UK continues to be one of the most mature and diverse real estate markets in the world, but the proposed changes will potentially impact the economic return for overseas investors and therefore such investors may need to adapt their financial models to take into account the relevant new tax charges.

1. DISPOSALS BY NON-UK RESIDENTS OF INVESTMENTS IN UK LAND

From April 2019, all non-UK resident persons will be taxable on gains on disposals of interests in any type of UK land or buildings. Changes introduced will apply not only to disposals of directly owned interests in UK land or buildings, but also to disposals of indirectly owned interests, i.e., the sale of interests in entities whose value is derived from UK land and buildings.

The Finance Bill amends the existing provisions of the Taxation of Chargeable Gains Act 1992 (TCGA) Part 1 and introduces a new charge to Capital Gains Tax (CGT) or corporation tax on non-UK resident persons making gains on direct or indirect disposals of UK property.

What is UK Land?

The definition of an interest in UK land in the Finance Bill follows existing definitions under the UK tax code and is designed to capture the whole profits relating to UK land and buildings. To summarise, an "interest in UK land" will include:

- an estate, interest, right or power in or over land or buildings in the UK; or
- the benefit of an obligation, restriction or condition affecting the value of an estate, interest, right or power in or over land or buildings in the UK.

However, it will not include:

- icences to use or occupy the land or buildings (e.g., permission to enter or use a building (such as an admission ticket or parking permit), as distinguished from a right attaching to the land, such as a lease – there are difficult cases at the margin;
- any right or interest held for securing the payment of money or the performance of an obligation (e.g., a right over land held by a bank as security for a loan); and
- certain other interests (e.g., a tenancy at will or a franchise).

Direct Disposals

From April 2019, all non-UK residents, whether liable to CGT or corporation tax, will be taxable on gains on disposals of directly held interests in any type of UK land.

Indirect Disposals

From April 2019, non-UK residents will also be taxed on any gains made on the disposals of significant interests in entities that directly or indirectly own interests in UK land. For tax to be imposed, the entity being disposed of must be "property rich", and the non-UK resident must be a "substantial investor".

Substantial Investor

A non-UK resident is a substantial investor in a property rich entity if, at the date of disposal or at any time within two years prior to disposal, the non-UK resident holds, or has held directly or indirectly, at least a 25% interest in a property rich entity. If the non-UK resident holds the 25% interest for an insignificant time period (relative to the total ownership within two years prior to the disposal), the 25% test will not be met.

The 25% interest is determined by voting rights, income rights, rights on a winding up and rights to proceeds on a sale.

Property Rich Entities

An entity is property rich if at least 75% of the gross market value of its qualifying assets at the time of disposal are derived from UK land. This includes value deriving from any:

- shareholding in a company deriving its value directly or indirectly from UK land;
- partnership interests deriving their value directly or indirectly from UK land;
- interests in property held on trust; and
- option, consent, or embargo affecting the sale of the UK land.

The qualifying asset test includes a complicated matching rule which can exclude some assets (e.g., relevant intercompany loans), and this will lead to the need for valuations for all qualifying assets and not just real estate assets.

The Finance Bill contains tracing and attribution of value provisions. Those provisions provide that non-UK residents own an asset deriving 75% of its value from UK land if they:

- own a right or interest in a company; and
- at the date of the disposal, at least 75% of the total market value of that company's qualifying assets derive directly or indirectly from interest in UK land.

Deriving the market value of a company will involve tracing through any arrangements and entities (including subsidiaries, partnerships and trusts). When tracing through such arrangements and entities, there must be appropriate attributions to the shareholders, partners and beneficiaries.

Trading Exemption

Exceptions apply where all of the interests in UK land are used for a qualifying trading purpose (e.g., a factory owned by a manufacturing business). Interests in land that are not used for a qualifying trading purpose are ignored if they are insignificant. A reasonableness test is used to determine what constitutes an "insignificant interest", taking into account all of the circumstances.

Connected Companies Exemption

Where two or more companies are disposed of as part of an arrangement and some, but not all, of these companies would meet the 75% property richness test, then special rules apply.

If, taken together, the assets of all of the companies aggregated do not meet the 75% property richness test, then none of the companies will be considered to have met the test. Such disposals by non-UK residents will therefore fall outside the changes brought in by the Finance Bill to UK tax on capital gains.

Anti-avoidance

The Finance Bill also introduces anti-avoidance provisions that apply to the new rules on indirect disposals by non-UK residents of UK land. These rules apply where the non-UK resident tax payer enters into an arrangement, the main purpose of which (or one of the main purposes of which) is to obtain a tax advantage and either:

- the tax advantage relates to tax for which that person would be liable (but for the arrangement) under the CGT regime and the arrangements were entered into on or after 6 July 2018; or

- the advantage arises in the context of a double taxation arrangement (i.e., a "treaty shopping case") and the arrangements were entered into on or after 22 November 2017.

Re-basing

There are now two key re-basing dates: 5 April 2015 and 5 April 2019. The default date for re-basing is identified by determining whether the non-UK resident disposal falls within one of the below categories:

- *Directly held commercial property*: Non-UK residents disposing of UK commercial property directly held at 5 April 2019 may re-base the land to its 5 April 2019 market value or elect to use the original base cost. Where a taxpayer takes the latter approach, any loss arising will not be an allowable loss.

- *Directly held residential property within NRCGT or ATED*: Non-UK residents disposing of UK residential property directly held since 6 April 2015 and chargeable to CGT prior to 6 April 2019 (i.e., UK land that was subject to the non-resident CGT regime or that would have been subject to ATED-related CGT had it been disposed of on or before 5 April 2019), may re-base the land to its 5 April 2015 market value or elect to use the original base cost. Alternatively, the taxpayer may elect for a straight-line time apportionment of any gain.

- *Directly held residential property outside NRCGT or ATED*: Non-UK residents disposing of UK residential property directly held at 5 April 2019 that was not chargeable on or before this date (i.e., residential property held by widely held non-UK resident companies, widely marketed collective investment schemes or non-UK resident life assurance businesses) may re-base the land to its 5 April 2019 market value or elect to use the original base cost. Where a taxpayer takes the latter approach, any loss arising will not to be an allowable loss.

- *Directly held mixed use property:* Non-UK residents disposing of UK mixed use (i.e., commercial and residential use) property directly held since 6 April 2015 and partly chargeable to CGT prior to 6 April 2019, may re-base the land to its 5 April 2015 market value and then again to its 5 April 2019 market value. The amount of any gain or loss accrued on the residential element on the re-basing to its 5 April 2019 market value is brought into charge to tax on the eventual sale. The non-UK resident taxpayer also has the option of using the original base cost, rather than re-basing the asset value.

- *Indirect interests*: Non-UK residents disposing of UK property indirectly held (i.e., through one or more corporate entities) will rebase the shares to their 5 April 2019 market value or elect to use the original base cost. Where a taxpayer takes the latter approach, any loss arising will not be an allowable loss.

Corporation Tax

The UK property activities of non-UK resident companies will be brought within the scope of UK corporation tax from April 2020. They will be subject to UK corporation tax (rather than income tax) on their income from UK land from April 2020 – at which point the main corporation tax rate will be 17%.

The delay in bringing companies within the corporation tax regime means the application of corporate interest restriction rules, hybrid rules and limits to carried forward losses are equally delayed. However, companies will not be able to take advantage of the lower tax rate until such time.

Such companies will, from April 2020, become entitled to benefit from corporation tax reliefs such as the substantial shareholding exemption (SSE) and the no-gain, no-loss rules on intragroup asset transfers.

One point to note is the interaction of SSE and the corporate interest restriction rules. The Public Benefit Infrastructure Exemption (PBIE) provides a more generous interest deduction than the standard debt cap – and it is available to some owners of UK investment property. However, companies eligible to benefit from SSE are unlikely to be able to benefit from PBIE (and vice versa). Where it is possible to structure ownership of a property in a manner that could benefit from either PBIE or SSE, a choice will need to be made at the time the property is acquired as to which relief is likely to be more valuable.

There will be many situations involving indirect disposals where SSE may not be applied (e.g., on the disposal of a benefit of a debt or derivative deriving its value from UK land). Where SSE is not available, the application of the trading exemption (see above) will be crucial.

Reliefs

SSE is not available to non-corporate taxpayers (such as individuals and trustees). As noted above, where SSE is not available, the application of the trading exemption will be crucial.

It is not clear whether roll-over relief for capital reorganisations will be permitted if interests are exchanged in a property rich entity in consideration of the issue of interests in an acquisition vehicle which is not property rich.

Those who are exempt from capital gains for reasons other than being non-UK resident (e.g., pension funds and sovereign wealth funds) will continue to be exempt under the new rules.

Availability of losses

Losses arising to non-UK resident companies under the new rules will be available in the same way as capital losses for UK resident companies. CGT losses will follow the existing rules for NRCGT losses.

NRCGT losses and ring-fenced ATED-related allowable losses accruing to a non-UK resident company before 6 April 2019 are deductible from any corporation tax due by the non-UK resident on chargeable gains (to the extent they have not already been deducted from gains).

See also section 4 of this alert for further details on losses.

Collective Investment Vehicles

The default position for collective investment vehicles (CIV) will be that they are treated for capital gains purposes as if they were companies. The CIV definition in the legislation is broad, and should capture most UK property rich Jersey Property Unit Trusts (JPUTs) and Guernsey Property Unit Trusts (GPUTs), as well as widely-held offshore funds.

An investment in such a fund will be treated as if the interests of the investors were shares in a company, so that where the fund is UK property rich, a disposal of an interest in it by a non-UK resident investor will be chargeable to UK tax under the new rules. But the deeming provisions will not go as far as treating CIVs as having ordinary share capital, so they will not be able to rely on provisions or reliefs that require a relationship to be established between a parent and subsidiary, or common subsidiaries of a parent, through ownership of ordinary share capital.

One consequence of CIVs being treated as companies is that they will be subject to corporation tax after April 2020.

Non-Application of 25% Ownership Exemption for CIVs

Non-UK resident investors in CIVs that are UK property rich will be chargeable on gains on disposals of an interest in a UK property rich CIV regardless of their level of investment. They will not benefit from the 25% ownership threshold.

The usual 25% substantial indirect interest test may be re-applied for certain funds where the CIV is only temporarily UK property rich. In these cases, the fund will need to meet a genuine diversity of ownership or non-close test, and be targeting UK property investments of no more than 40% of fund gross asset value in accordance with its prospectus or other fund documents.

The Transparency Election

CIVs that are already treated as transparent for tax purposes will be able to elect (irrevocably) to be treated as a partnership for the purposes of capital gains (and related provisions), thereby ensuring that the investors are taxed on disposals of the underlying assets of the partnership. Statement of Practice D12 (SP D12), and the usual taxation of partnership rules, will apply in calculating any gain or loss when the investor or the CIV makes a disposal.

An investor who is exempt from capital gains (e.g., pension funds and sovereign wealth funds) would therefore be able to directly claim exemption on the disposal of assets by the CIV.

In the case of a fund existing at 6 April 2019, the election must be made by 5 April 2020.

The election can be made by the fund manager, and must be accompanied by the consent of all of the investors in the fund at the time of making the election. The investors' consent may be assumed where it is evident that it has been made clear to investors that they are buying an interest in a fund that intends to make a transparency election.

To qualify for the transparency exemption, the CIV will need to either be UK property rich at the time of the election, or have published scheme documents at that time clearly stating the intention of the CIV to invest predominantly in UK land.

The transparency exemption is unlikely to be appropriate for CIVs that have regular changes of investors, as these changes may trigger regular disposals of other investors' interests in the underlying assets because of the way in which SP D12 deals with the introduction and withdrawal of partners in a partnership.

The Exemption Election

Under the election for exemption, the CIV itself will not suffer tax on either direct or indirect disposals on the proportion of any gains attributable to the CIV holding UK land. The investors remain taxable under first principles on any disposal of an interest in a CIV that is a UK property rich entity.

The election for exemption is not available to all funds. It is only available to non-UK resident companies that are the equivalent of UK REITs and some partnerships.

An extensive set of qualifying criteria needs to be met in order to be able to make the election for exemption. In particular, these include a requirement for diverse ownership of the CIV.

Where a CIV ceases to meet any of the qualifying criteria, this will trigger a deemed disposal and reacquisition of the interests of all the investors in the CIV. Certain reporting obligations apply in these instances. Tricky provisions apply where the CIV falls in and out of the conditions over certain periods of time.

CIV Reporting Obligations

Not only will CIVs and investors in the CIVs need to understand the new tax regime, they will also need to understand the new reporting obligations. CIVs will be required to make annual filings with HMRC providing details of the CIVs' investors and disposals (if any).

For CIVs established prior to 1 June 2019 there are dispensations in the information required where the manager is otherwise prevented from providing such information to HMRC for legal, regulatory or contractual reasons and so fund managers will need to review their constitutional documents to see if the obligations apply.

2. REPORTING AND PAYMENTS ON ACCOUNT OF CAPITAL GAINS

With effect from 6 April 2019, disposals of UK land by non-UK resident persons must be reported within 30 days of completion, and payment on account of the tax liability must be made by the same date.

This 30-day time limit also applies to disposals made by non-UK resident investors in CIVs. Where a fund is fiscally transparent, arrangement will need to be in place for fund managers to notify their investors when disposals occur.

With effect from 6 April 2020, direct disposals of UK land on which a residential property gain accrues (by both UK residents and non-residents) must be reported within 30 days of completion, and payment on account of the tax liability must be made by the same date.

3. ANNUAL TAX ON ENVELOPED DWELLINGS

ATED-related CGT will be abolished with effect from April 2019, as the new rules set out in section 1 of this alert would now cover disposals that would otherwise have been caught under the ATED-related CGT provisions.

ATED will continue to apply as an annual tax. The rates of ATED will increase by 2.4% (in line with the consumer prices index) with effect from 1 April 2019.

4. CORPORATE CAPITAL LOSS RESTRICTION

To ensure that large UK companies pay tax when they make significant capital gains, new rules will bring the tax treatment of corporate capital losses into line with the treatment of income losses. From 1 April 2020, the proportion of annual capital gains that can be relieved by brought-forward capital losses will be restricted to 50%. This will be relevant to non-UK resident property companies, when they come within the charge to UK corporation tax in April 2020.

The measure will include an allowance that gives companies unrestricted use of up to £5 million capital or income losses each year.

The measure will be subject to anti-avoidance rules that apply with effect from 29 October 2018.

5. CAPITAL ALLOWANCES

The Finance Bill includes provisions for a new form of capital allowance relating to costs incurred in the construction, conversion or renovation of new commercial property – to be known as Structures and Buildings Allowance.

The Structures and Buildings Allowance is subject to consultation, but it is expected to be given at a flat rate of 2% per annum over a 50-year period.

The Finance Bill also includes the following additional provisions:

- An increase to the Annual Investment Allowance from £200,000 to £1 million from 1 January 2019 until 31 December 2020.
- A reduction of the capital allowances special rate from 8% to 6% from April 2019. The main pool rate will remain at 18%.
- An end to the Enhanced Capital Allowances and First Year Tax Credits for technologies on the Energy Technology List and Water Technology List from April 2020.
- An extension to the first year allowance for electric charge-points for four years until April 2023.

6. STAMP DUTY LAND TAX

For transactions completed on or after 1 March 2019, the filing deadline for SDLT returns and the payment of SDLT will be reduced from 30 days to 14 days.

The Government intends to consult on introducing a new 1% SDLT surcharge on the acquisition of residential property in England and Northern Ireland by non-UK residents. The consultation document will be published in January 2019.

7. VAT REVERSE CHARGE FOR BUILDING AND CONSTRUCTION SERVICES

The Finance Bill introduces a VAT reverse charge on certain building and construction services that will come into effect on 1 October 2019. These rules are intended to reduce tax fraud within the construction industry where sub-contractors charge VAT, but disappear without accounting for HMRC for such VAT.

The new rules will, in many cases, require the recipient of the supply of construction services (rather than the supplier) to account for VAT on the supply.

The reverse charge will apply through the supply chain where payments are required to be reported through the Construction Industry Scheme up to the point where the customer receiving the supply is no longer a business that makes supplies of specified services, i.e., "end users".

8. INTERNATIONAL TAX ENFORCEMENT: DISCLOSABLE ARRANGEMENTS

The Finance Bill includes powers for the Government to make regulations to implement Council Directive 2018/822/EU (DAC6), which requires EU intermediaries (including banks, accounting firms, law firms, corporate service providers and certain other persons) involved in cross-border arrangements to make a disclosure to their tax authority if certain requirements are met.

DAC6 is intended to give tax authorities early notice of new cross-border tax or avoidance schemes. This is intended to enable the authorities to investigate users and, if necessary, close down the schemes with legislative changes. DAC6 is widely drafted and clients with cross-border arrangements anywhere in the EU are advised to check whether arrangements entered into from June 2018 do not trigger a notification requirement.

CONCLUSION

As set out above, numerous tax changes have or will be implemented, each of which could impact the economic return for overseas investors with interests in UK real estate. Investors should consider the different UK tax implications that result from investing in such assets directly and indirectly. It will also be important to bear in mind that the nature of any potential transaction (and the level in the relevant structure at which the transaction occurs), as well as the type of entities involved, could create differences in the tax result and there may be no obvious policy reason as to why this should be the case. Therefore, investors will need to consider their individual positions accordingly.

For example, the draft NRCGT legislation is intended to more closely align the tax treatment of non-UK residents with that of UK residents. Whether this is actually the case is very much open to debate. The funds industry was initially very concerned about this proposal, particularly given that funds and joint ventures are often structured to facilitate tax-exempt investors investing alongside taxable investors in such a way that no more tax is paid than if they acquired any assets directly. The original draft rules could have taxed such structures at multiple levels and various changes to the draft legislation have sought to address this, but some gaps and concerns still remain. It will also be important to monitor the ongoing efforts to bring non-resident property companies within the corporation tax regime from April 2020, as there remain a number of technical issues to be finalised, as well as fundamental differences in how capital gains are calculated depending on which part of the UK tax code an entity falls within (e.g., indexation for corporation tax payers).

Gibson Dunn's lawyers are available to assist with any questions you may have regarding these developments. For further information, please contact the Gibson Dunn lawyer with whom you usually work or any of the following members of the Tax Practice Group:

Sandy Bhogal - London (+44 (0) 20 7071 4266, sbhogal@gibsondunn.com)
Nicholas Aleksander - London (+44 (0)20 7071 4232, naleksander@gibsondunn.com)