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Changes to the UK's Regime for Taxing Gains on Real Estate: Does This Affect Your Real Estate Fund?

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With effect from 6 April 2019, non-UK residents will become subject to tax on chargeable gains arising from the disposal of all UK land, including commercial and residential real estate (the "NRCGT Regime").

Prior to the introduction of the NRCGT Regime, gains on UK real estate by non-UK residents were generally not liable to UK taxation, although this position was being gradually eroded by various pieces of legislation targeted at specific circumstances. The NRCGT Regime will go a long way to achieving the government's stated intention of levelling the playing field between domestic and overseas investors in UK real estate, as well as between gains in respect of both commercial and residential property, with the resulting tax considerations becoming a new reality for many non-UK investors.

The new regime taxes both direct and indirect disposals by non-UK residents of UK real estate, whether residential or commercial. Under the NRCGT Regime, non-UK residents will be subject to tax on all gains realised on their UK real estate assets, subject to various exemptions and reliefs. In addition, certain aspects of the NRCGT are intended to minimise the impact of the potential changes at the investor level, including the option for collective investment vehicles ("CIVs") to elect to be treated as transparent or exempt. Particular consideration should be given to whether the CIV is eligible to make these elections and the timing for doing so.

Given the complexity of the legislation and the fact that the NRCGT Regime introduces a significant change to the scope of the taxation of UK real estate, it is important to examine current investment and holding structures so as to understand the impact of the NRCGT Regime and the consequences of any restructuring.

Previous Regime

Owing to the territorial limits of the taxation of UK real estate, non-UK residents have generally been outside the scope of UK taxation in respect of income and gains derived from UK real estate. This regime had helped establish UK real estate as an attractive asset class and facilitated the establishment of tax-neutral structures for inward investment, especially when compared with the position of other jurisdictions.

However, in recent years, legislation targeted at specific holders of UK real estate has been introduced to remove some of the distinctions between the taxation of residents and non-residents and distinctions between the taxation of residential and commercial real estate. For example, a non-resident company carrying on a trade in the UK through a UK permanent establishment is chargeable to UK corporation tax on profits attributable to that permanent establishment, wherever such profits arise. In addition, changes were introduced in 2016 to bring gains realised by non-UK residents on the disposal of UK land or property that derives at least 50% of its value from UK land within the charge to UK taxation.

NRCGT Regime

With effect from 6 April 2019 non-UK residents will be subject to tax on gains realised on their UK real estate assets. The NRCGT Regime taxes direct disposals as well as indirect disposals of UK real estate and includes disposals in the course of an investment activity. Set out below is a high-level overview of some of the key features of the NRCGT Regime.

What are "Indirect Disposals"?

For the purposes of the NRCGT Regime, indirect disposals are the sale of interests in "property-rich" vehicles by a person who has a substantial indirect interest in the UK land. A vehicle is "property rich" for these purposes if it derives at least 75% of its value from UK real estate. Broadly, a person will have a "substantial indirect interest" where they have held a 25% investment in that property-rich vehicle. These provisions are subject to a two-year holding period, and interests can be aggregated with interests held by related parties. The application of this 25% threshold to investors in CIVs is considered further below.

Exemptions and Reliefs

Non-residents should consider the availability of existing exemptions and reliefs that are available to resident investors for the purposes of determining chargeable gains. Broadly, investors that are exempt from chargeable gains (such as overseas pension schemes and sovereign wealth funds) should continue to be exempt under the NRCGT Regime.

The NRCGT Regime includes a "trading" exemption which applies to indirect disposals (including disposals by non-corporate shareholders) of interests in companies with real estate-heavy trades. This exemption applies if it would be reasonable to conclude that (so far as the market value of the company's assets derives, directly or indirectly from UK real estate) all of the interests in UK land are used for a trading activity, or all of the interest in the UK land would be used for that trading activity if any UK land assets used for non-trading (investment) purposes is no greater than 10% of the market value of the UK land held by the Company for trading purposes.

The current “substantial shareholdings exemption” (“SSE”) for trading companies also continues to be available in the context of indirect disposals. The SSE exemption may be preferred to the “trading” exemption on the basis that the non-trading activities test in the SSE uses a 20% threshold to determine whether or not the trading requirement is met. However, the “trading” exemption should prove to be available to a wider class of investors, including non-corporate shareholders such as individuals and unit trusts.

Further, where a property-rich company is owned by an appropriate proportion (80%) of “qualifying institutional investors” (including pension funds, charities and sovereign wealth funds) for SSE purposes the trading requirement is dropped altogether.

Double tax treaties

The UK-Luxembourg double tax treaty currently prevents the UK from taxing gains on disposals by Luxembourg residents of interests in UK “property-rich” vehicles. This position will continue to preserve the current taxation treatment for these vehicles under the NRCGT Regime. However, the UK is in the process of renegotiating the real estate-related provisions in the Luxembourg treaty, so the protection may not be available in the future. The NRCGT Regime also contains anti-forestalling provisions to prevent new structures being established in Luxembourg in order to take advantage of this protection.

Rebasing

The NRCGT Regime provides for the rebasing of assets held on 5 April 2019 that have not come into charge before April 2019. Alternatively, an election can be made for calculating a chargeable gain in accordance with the usual rules, where this produces a beneficial result, although there are limitations around this producing a loss.

Collective Investment Vehicles (“CIVs”)

Non-UK investors in CIVs that are not partnerships would otherwise be treated as if they owned shares in a company and could therefore be within the charge to UK tax on any gains realised on a disposal of their CIV interests. Non-UK investors in CIVs that are partnerships may be within the charge to tax on gains realised on disposals of underlying UK land.

The NRCGT Regime provides CIVs with the option to make certain elections so as to reduce the potential for double taxation of the fund and investors. Owing to the importance of “tax neutrality” for investors (such as pension funds and other exempt institutional investors) in these structures, this is an important feature of the NRCGT Regime and a welcome concession from the UK Government.

The 25% ownership requirement for the purposes of the application of the NRCGT Regime to indirect disposals will not apply to investors in CIVs (whether that CIV is a partnership or not), investors in companies that derive more than 50% of their value from one or more CIVs, or disposals by CIVs themselves or by companies in their ownership. However, the 25% ownership requirement will apply to investors in CIVs that were marketed on the basis that no more than 40% of the CIV’s market value will be derived from interests in UK land or UK property-rich companies.

A CIV can elect to be regarded as either “transparent” or “exempt”.

A CIV which is transparent for tax purposes (for example, a Jersey property unit trust (“JPUT”)) can elect to be transparent for the purposes of the NRCGT Regime. By making a transparency election, the CIV will be treated as a partnership for the purposes of chargeable gains calculations. In particular, the CIV will not itself be subject to tax but UK and non-UK resident investors will be subject to tax on any gains realised on a disposal of the underlying assets.

The availability of this election is expected to result in JPUTs continuing to be an integral part of real estate structures in respect of UK land. From a compliance perspective, transparency elections are irrevocable and must be made within one year of the vehicle acquiring UK property. Existing CIVs have until April 2020 to make a transparency election, subject to the consent of all unitholders.

Alternatively, in certain circumstances, a CIV can make an exemption election. A CIV will be eligible to make an exemption election where it is a property-rich entity and meets one of a number of ownership conditions (by reference to being widely marketed, or for non-close entities, the ordinary share capital is traded on a recognised stock exchange or 75% of the CIV’s value would be returned to investors on a winding up).

The effect of making an exemption election is that while the CIV (and any other elected entities) remain persons notionally chargeable to tax on gains, they will be exempt from tax on direct and indirect disposals of UK land. UK resident and non-UK resident investors will instead be subject to tax on any gains realised on a disposal of their interest in the CIV. Unlike the transparency election, the exemption election can be revoked. In addition, CIVs making an exemption election will have certain reporting obligations to HMRC (such as providing details of the CIV’s investors and their tax status together with the value of any disposals the investors made in the relevant period). However, HMRC acknowledges that some funds may either not hold this information or be permitted under the terms of the CIV’s constitution to disclose these details.

Non-UK investors should be aware that they may have UK tax filing obligations as a result of such elections being made. The practical impact of this position may be softened in the future, as HMRC is considering new rules that would allow funds to file returns and pay tax on behalf of their investors.