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Dear James

HMRC and HMT Consultation Document: Taxing Gains Made by Non-Residents on UK Immovable Properties

The Association of Real Estate Funds[1] ("AREF") welcomes the opportunity to respond to the HMRC and HMT consultation *Taxing Gains Made by Non-Residents on UK Immovable Properties*.

We would like to make a number of general comments before we address the specific questions raised in the consultation document.

Given the complexity of these issues we would welcome the opportunity to explore the issues and potential solutions with you and your Collective Investment Scheme colleagues in more detail.

<u>Key points</u>

- **Tax exempt investors-** Our focus is on tax exempt investors to ensure these rules do not create tax costs for UK or overseas tax exempt investors such as pension funds.
- **CIVs-** This is a complex area and requires time and care to ensure that exempt investors are not subject to tax charges or that other investors are not subject to double tax.

[1] The Association of Real Estate Funds represents the UK real estate funds industry and has around 60 member funds with a collective net asset value of more than £60 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the AREF/IPD UK Quarterly Property Funds Index and the AREF/IPD Property Fund Vision Handbook.

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Other main points

- **Market concerns-** We have concerns around the impact of these changes particularly in relation to the timing and Brexit and the impacts that these may have on UK property prices and market liquidity.
- **Proposed solutions-** We consider the best solutions will ensure any tax is levied directly on investors. This can be achieved by treating CIVs as, preferably, subject to equivalent treatment as for UK funds or transparent.
- **Infrastructure-** consideration is required as to the definition of real estate and whether infrastructure assets should be excluded.
- **UK vehicle requirement-** our view is that a suitable UK vehicle is required as an alternative to offshore vehicles- it needs to be suitable for a mixed investor base and not be required to be open-ended or listed.

Overall - AREF is supportive of the Government's aim to create a level playing field in respect of the taxation of UK and non-UK resident investors on real estate capital gains. In addition, we welcome the Government recognition that the impact of the rules on non-residents investing through CIVs and on the funds industry as a whole needs to be considered carefully and we are grateful for the opportunity to work with you to create a coherent and robust regime.

One notable area not yet commented on by the Government or HMRC, but which is of huge relevance to non-resident investors in UK property and the structuring of their investments, is the SDLT treatment of property-rich investment vehicles. Clearly under current law interests in such vehicles, if opaque, are not charged to SDLT. We would very strongly urge HMRC to make clear alongside the CGT reform the policy intentions with respect to the future SDLT treatment of these vehicles.

Tax exempt investors - Our key focus is to ensure that pension schemes (UK and overseas) and other tax exempts (e.g. Sovereign Wealth Funds) should not be adversely impacted by the changes. This should be the case whether they invest in UK real estate directly or through collective investment vehicles, or indeed through other investment holding vehicles (e.g. non-UK resident property holding companies wholly owned by the tax exempt investor).

We have discussed this with AREF members and the indication is that circa 75% of the investors in member funds are UK or overseas tax exempt investors.

Collective investment vehicles and other indirect investment vehicles - A key concern is that tax exempt investors in CIVs do not end up suffering a layer of tax on gains which they are unable to reclaim.

We would urge the Government to ensure that time is taken to consider these complex issues fully which may mean that the implementation date in respect of the rules for CIVs has to be pushed back. Alternatively, we would suggest a more simple solution is implemented.

Market concerns - We are concerned that introducing rules to tax non-UK residents on UK property so close to the Brexit date could lead to criticism of Britain not being "open for business" post Brexit.

Wider uncertainty around the potential impact of Brexit may increase the potential risk to UK property values. It may produce short-term behaviours such as non-UK investors rapidly reducing exposure to UK property or, conversely, may lead to a lack of activity in the market. Either of these could materially affect pricing and liquidity.

We are aware of research by Colman Parkes[1] which indicates that the UK leaving the EU in 2019 has already had an impact in investment allocation to UK real estate and this will continue. In 2016/17 and so far in 2018 Brexit has resulted in a lower allocation for over half of investors. Their report also indicates that 65% of real estate investors predict *extra* uncertainty well into 2020 and beyond, caused by the proposed extension of the UK tax regime, coupled with Brexit.

Proposed solutions - The ideal solution is to ensure the point of tax is not on CIVs but on investors themselves.

We consider the optimal treatment would be to treat offshore funds in the same way as UK funds such as Authorised Property Unit Trusts, Property Authorised Investment Funds, Authorised Contractual Schemes (under SI 2017/1204) or UK REITs. Aligning the rules for offshore CIVs with the taxation of UK funds would reduce the risk of the treatment being deemed to be discriminatory under the EU principle of free movement of capital.

Equivalent treatment would involve investors being subject to tax on the disposal of interests in, or return of capital from, CIVs but disposals of assets by a CIV would not be subject to tax.

The treatment of disposals of interests in Jersey Property Unit Trusts and similar property-holding entities by CIVs will need further consideration.

The main alternative we see is to treat CIVs as being completely tax transparent for these purposes. The result of this would be to tax investors on capital gains directly. However, this treatment is complex, particularly in the case of open-ended funds where investors and fund managers would need to maintain information in respect of each investor's base cost for each property. It could also lead to "dry" tax charges where investors are taxed on gains but receive no cash to pay the tax.

Infrastructure - While recognising that this is a political decision, we would also suggest that consideration is given to the types of property intended to be captured. In particular, consideration is required as to whether infrastructure investments should be carved out.

If infrastructure investments were to be subject to the new rules there is a risk that it could have significant impact on the availability of capital to fund public benefit projects.

UK alternative structures - There is currently no suitable onshore alternative to a Jersey or Guernsey Property Unit Trust. The existing UK vehicles do not offer some of the non-tax benefits that overseas vehicles offer, which is often the reason for non-UK investment fund structures.

A UK vehicle which allows a mixed investor base and does not have the open-ended requirements of existing UK regulated funds should enable more CIVs to be set up as UK vehicles in future. With the

[1] Colman Parkes Research- February 2018

ongoing FCA review into open-ended property funds, this makes planning to set up a new fund under these regulations extremely challenging.

With appropriate tax reliefs for the transfer of assets from offshore structures to UK funds there is a chance that some funds will decide to "move onshore" (subject to cost / benefit analysis).

We would support the introduction of a UK equivalent vehicle (which may be achieved most easily by amendments to existing vehicles) and would be happy to work with you on this going forward.

Specific responses to the consultation

The key chapter for AREF is Chapter 6 relating to Collective Investment Vehicles. We have set out our responses to these questions below.

Our response to the questions relating to other chapters have been included in the Appendix as, while these are important, they are of less relevance to the AREF membership.

Chapter 6: *Collective Investment Vehicles*

18) Do you agree with the general approach to ownership of non-residential property through CIVs outlined above?

AREF are supportive of the Government's aim to create a level playing field in respect of UK and non-UK residents. In addition, we welcome the Government recognition that the impact of the rules on non-residents investing through CIVS and on the funds industry as a whole needs to be considered carefully and we are grateful for the opportunity to work with you to create a coherent and robust regime.

Currently, under Chapter 6, it is not clear how the rules will impact CIVs and, as such, we cannot agree with the approach outlined in this chapter as it stands.

In particular, the requirement to apply the property richness and ownership threshold tests for indirect disposals will be onerous and lead to a number of complexities.

We also note that there are no specific exemptions in Chapter 6 that would be available to certain investors which invest through CIVs.

A final point to note, particularly in the light of Brexit, is the EU fundamental principle of free movement of capital which applies to third countries. Careful consideration should be given to these rules to ensure that non-UK CIVs / non-residents investing into UK CIVs are not discriminated against compared to UK CIVs / UK resident investors.

19) Will the proposals for CIVs mean that you will now be required to register for UK tax?

Yes.

20) Will the proposals for CIVs lead to an increase in your administrative burdens or costs? Please provide details of the expected one-off and ongoing costs.

Yes, we would expect to see an increase in administration and costs, however the lack of detail in Chapter 6 means we are not able to estimate such costs.

21) Are there changes needed to the rules for CIVs, particularly around exemptions, to ensure a robust system of taxing non-residents on gains on disposal of interests in UK property?

The proposed rules for CIVs create a number of issues and uncertainty.

In particular, we consider that there will be an EU discrimination issue if overseas CIVs are not treated in an equivalent manner to UK CIVs. We understand that this principle will continue to apply post Brexit and hence this will be an ongoing issue.

The particular points that we consider to be problematic are:

- The availability of exemptions, for example, where tax exempts (e.g. pension funds) invest via CIVs;
- The 25% test, 5-year look back period and acting together rules;
- The property rich test;
- The interaction with SI 2017/1204;

We consider each of these issues in more detail below.

Exemptions for tax exempts -tax exempt investors are incredibly important investors in UK property. The key concern is in ensuring that there are not tax liabilities within funds or other entities in which tax exempt investors have interests (either on disposals by a fund itself or by entities within a structure) which a tax exempt investor cannot reclaim.

The 25% test, 5-year look back period and acting together rules- Whilst the suggestion that sub-25% holdings would not be included to exclude smaller investors is welcome, the other requirements around this test create uncertainty and are administratively difficult to manage.

In particular, the requirement to monitor holdings over a 5 year period is administratively difficult for investors and funds. Furthermore, the impact of this test for seeding of funds or in wind-down needs consideration. This test could distort commercial behaviour.

Similarly, the rules around parties acting together create uncertainty for investors. For example, would partners in a limited partnership or investors advised by the same multi-manager advisor be considered to be acting together? AREF's view is that they should not be so considered, when they are otherwise not related.

Property rich test - there are also issues with ascertaining whether at the time of disposal, directly or indirectly, 75% or more of the value of the asset disposed of derives from UK land. Again, we are concerned that this could distort commercial behaviour and could make relative valuations of assets increasingly important. Whilst the hurdle level of 75% appears reasonable, we would suggest that the rule needs to be amended such that the tax charge arising is only on the element of UK property rather than on the entire value as appears to be the case now. Whilst there may be an ability to obtain double tax relief, that would be a burdensome process which could be avoided.

SI 2017/1204 - we consider that SI 2017/1204 will be important in relation to offshore vehicles. Particular thought needs to be given to the treatment of tax exempt investors and maintaining this treatment could ensure that tax exempt investors are not disadvantaged.

Proposed alternative

As indicated above, we consider that any change which treats overseas CIVs differently to UK funds will be open to challenge on discrimination grounds (free movement of capital).

We are also concerned that a number of the cliff-edge tests would impact commercial behaviour.

As a result, we would suggest that CIVs are treated in a way similar to UK funds (such as PAIFs and UK REITs).

To achieve this we would propose that:

- Tax on gains is not levied on disposals of property or property rich entities by widely held CIVs.
- Investors are subject to tax on capital gains on disposals of their units in the CIV itself.

This would create a level playing field between UK and non-UK collective investment schemes.

Additionally, ensuring that the point of tax is at the investor level would help with ensuring that pension schemes are not subject to tax and that other investors are not subject to double tax or economic double taxation.

It is also important that investors are not subject to "dry" tax charges where they are subject to tax on disposals but do not receive a distribution.

Furthermore, this would remove many of the complexities highlighted above and would be relatively straightforward to implement in the short term.

Impacts on other proposed rules

We would suggest that to achieve this the 25% holding test, the 5 year look back and the "acting together" test would not be required which would remove a large part of the complexity and uncertainty from the current proposal.

Other potential impacts - sale of / by subsidiary entities

This proposal may have impacts on properties held by funds through individual asset holding entities where a sale could be effected through a sale of the underlying entity or by sale of the property itself.

Our view is that the sale of the underlying property itself should not be subject to tax within the fund or on investors (unless capital is returned to them) to ensure there is no risk of double taxation. It should also be noted that a purchaser would be subject to SDLT on the transaction.

Ideally there would be no capital gains tax either if an individual asset holding entity was sold by the CIV in the same way as the sale of intermediate holding vehicles sold by a UK authorised investment fund or an exempt unauthorised unit trust. We recognise, however, that the disposal of interests in an asset-holding entity is potentially more complex. A parallel could also be drawn to the REIT regime where disposals of interests in JPUTs and equivalent are subject to tax within the REIT.

However, we would draw a distinction in that here we are dealing with existing structures. If the future treatment of property holding vehicles was to treat them in a similar manner to those within a REITs structure then we would suggest that time and adequate reliefs should be provided to allow funds to amend their property holding structures.

This issue is also relevant to fund of fund structures which will also be heavily invested in by tax exempt investors. In those structures there are likely to be disposals at the fund of fund level (as well as within the funds themselves) and hence this is an important issue to resolve.

These issues are complex and we would welcome the opportunity to discuss them with you further.

Alternative option - transparency

We have considered whether look-through treatment would be an appropriate alternative. The key benefit would be to keep the liability at the investor level which would help to ensure that tax exempt investors are not unfairly impacted by these changes.

If this option were to be considered further there are a large number of issues that would need to be considered and our view would be that implementation by the current timetable would create significant risk for investors.

We suggest that in any event the intended CGT treatment of a "tax transparent fund" should be clarified. Specifically will an offshore fund which is a transparent fund continue to be outside the scope of UK CGT on UK property gains? Certain offshore vehicles (such as FCPs and Channel Islands unit trusts) will, if open-ended, tend to be 'tax transparent funds' within the terms of SI 2017/1204. They are very commonly used to invest in UK property. We invite HMRC to confirm that if such a fund does not own its property beneficially (because the property is held beneficially by the investors or a manager on their behalf), it will not be treated as disposing of the property for the purposes of the new CGT rules. In addition, as SI 2017/1204 provides that the investor's asset for CGT purposes is its interest in the fund, rather than the underlying property, in our view it should be confirmed by HMRC that such a disposal by the investor of its interest in the fund is an 'indirect' disposal for the purposes of the new CGT rules.

Applying SI 2017/1204 in this way still leaves unresolved the treatment of vehicles which are not 'offshore funds' and so are outside its effects (for example closed ended unit trusts, or other indirect investment vehicles which may not be collective investment schemes at all). As we have already indicated, provision should be made such that, in particular, tax exempt investors in these vehicles can also preserve their tax status irrespective of the level of the structure at which disposals are made.

Alternative structures

In terms of new structures (and any structures that fund managers and investors want to bring onshore), there is not an appropriate UK alternative to the offshore vehicles such as JPUTs and GPUTs.

The key issues with the UK alternatives are as follows:

Exempt UUT - the inability to mix taxable investors with non-taxable investors is a severe drawback.

REITs - the listing requirement and the 10% distribution test are issues. Whilst the 10% test can be mitigated for some corporates through fragmentation of holdings, it is not an effective solution for all investors. For example, it does not work for the UK life companies which have historically seeded many real estate investment funds. Perceived equity market volatility is also a concern.

UK authorised funds - the regulatory requirement for these to be open-ended is a key issue. The ongoing FCA review is increasing the uncertainty in this area.

Requirements for alternative vehicle

We would strongly suggest that consideration is given to creating an alternative UK vehicle which does not need to be open-ended or listed. This may be achievable by amending existing vehicles.

We would also suggest that reliefs be made available to ensure that existing offshore vehicles can be transitioned into the new structure more easily without any tax cost (SDLT in particular).

In this regard we would strongly suggest that moving vehicles onshore should not be mandated as it would create significant costs and compliance obligations e.g. stamp duty, property due diligence etc. Property due diligence can be a significant cost on any fund transition and a decision to bring assets onshore will need to factor in the cost/benefit analysis in the particular circumstances.

For this reason a grandfathering provision could be introduced in order to allow offshore funds to choose whether to be treated as onshore entities but without the need to change structure.

22) Are there any specific circumstances where the treatment of gains on non-residential UK property should be different to the treatment of gains on UK residential property in the context of a CIV?

No.

23) Do you have any further comments on the taxation of gains on non-residential UK property held through CIVs?

Please refer to our response to question 21.

Next steps

Regarding further input into this consultation, we would welcome the opportunity to present our key points to you and your colleagues before the response submission deadline.

Thank you once again for the opportunity to respond to the consultation and we hope to continue to be able to continue our contribution. If you have any queries or require further information, please do not hesitate to contact me.

Yours sincerely

John Cartwright
Chief Executive

Appendix: specific responses to consultation.

<u>Chapter 2: *Scope of the Measure*</u>

1) Are there any issues specific to non-residents when considering how they fit into the UK definitions of persons chargeable to UK tax (CGT or CT)?

A key concern is the treatment of non-resident pension schemes and whether they will be exempt from the rules.

The changes to the treatment of non-resident landlords, effective from April 2020, mean that the income that non-resident companies receive from UK property will be chargeable to corporation tax rather than income tax. Also from April 2019, gains that arise to non-resident companies on the disposal of UK property will be charged to corporation tax rather than CGT. These changes mean that all income and capital relating to UK property should all be subject to CT, however it not yet clear whether this would be the case. If this were to be the case, the potential to group relieve profits would be welcome.

In addition, the continuation and interaction of Statutory Instrument 2017/1204 with the new measures for non-residents is not clear, however we understand that HMT/HMRC will consider the position as set out in these regulations and whether it will be subject to change in the context of these new measures.

2) Do you see any issues or complications arising with respect to rebasing which need to be addressed?

Per paragraph 2.10, where rebasing may produce an unfair result, there is an option to compute the gain/loss on disposal using the acquisition cost as the base cost of the property. However, this applies to direct disposals only and, per paragraph 2.11, indirect disposals **must** rebase when computing the disposal. We consider that indirect disposals should also have the option to either rebase or use the acquisition cost in the case of an unfair result.

We consider a number of issues arising in respect of rebasing:

- Rebasing will require a valuation of the property as at April 2019. Not only is this onerous and costly, the date of April 2019 coincides with to the date of Brexit. This is expected to impact property valuations, the extent to which is not yet clear.
- The guidance is also ambiguous on whether or not rebasing should be on an asset by asset basis, which again could have implications on valuation.
- Linked with the timing, we have concerns that Brexit and other factors could mean that rebasing is at a low point in valuations. Investors and funds are likely to need to perform "April 2019" valuations and there is a risk that these show valuations at a point where loan to value covenants in loan documents could be stressed. Formal valuations at this point could be unhelpful when discussing loan to value covenants with lenders.
- Accounting provisions may also be required as a result of rebasing.
- In computing chargeable gains on assets, it is unclear whether such valuation costs would qualify as an allowable incidental cost of disposal. In this case, we would welcome a provision to allow

for the deduction of valuation costs, either in calculating gains or, preferably, as a revenue deduction if this suggested measure is to remain unchanged.

<u>Chapter 3: *Direct disposals*</u>

3) Do you agree with the basic principle that gains on direct disposals within these new rules should be computed using the same computational rules as other chargeable gains?

We agree with this principle as any other mechanism could introduce complexities.

4) Further to the specific modifications identified, are any other changes needed to recognise differences in how the tax system applies to non-residents?

The definition of non-resident tax exempt investors should be clarified, in particular, overseas pension schemes. We note that the government is currently considering the definition of overseas pension schemes separately. We would suggest that this definition should be consistent with the definition for non-resident CGT.

Consideration should also be given to how the pension businesses of overseas life companies are treated.

5) For businesses: Will the proposals for direct disposals mean that your company will now be required to register for UK CT?

We do not consider this question to substantially impact the AREF membership, however, generally, we expect it to be the case that companies will be required to register for UK CT for direct disposals.

6) For businesses: Will the proposals for direct disposals lead to an increase in your administrative burdens or costs? Please provide details of the expected one-off and ongoing costs.

We do not consider this question to substantially impact the AREF membership, however, generally, we expect this to be the case.

However, in respect of the changes to take effect from April 2020 which impact non-resident landlords ("NRLs"), NRLs may be obliged to register for CT in this regime from April 2019 but also be subject to IT in another regime. We note that this would only impact NRLs for one year, albeit additional administration issues will arise in respect of this.

A suggested approach could be the introduction of a simplified CT form for those impacted by the changes.

7) For individuals: Will the proposals for direct disposals mean that you will be required to pay Capital Gains tax for the first time?

We do not consider this question to impact the AREF membership, however, we would expect this to be the case.

Chapter 4: *Indirect disposals*

8) Do you consider that the rules for indirect transactions are fair and effective?

Broadly, yes, however the details of the new rules are currently unclear, making it is difficult to assess the impact in the context of the AREF membership. However, particular concerns are:

- Where a fund disposes of an interest in another fund (e.g. where a JPUT disposes of its interest in another JPUT).
- The treatment of partnerships – these should continue to be treated as transparent, however clarity on this would be welcome.
- Investments into infrastructure – we consider such investments should be exempt, for reason of public benefit.

We have responded in greater detail under Chapter 6 *Collective Investment Vehicles*.

9) Are any other conditions necessary to ensure the policy is robust in meeting the objective of taxing non-residents on gains on indirect disposals?

Please refer to Chapter 6 *Collective Investment Vehicles.*

10) For businesses: Will the proposals for indirect disposals mean that your company will now be required to register for UK CT?

Yes, however please refer to Chapter 6 *Collective Investment Vehicles.*

11) For businesses: Will the proposals for indirect disposals lead to an increase in your administrative burdens or costs? Please provide details of the expected one-off and ongoing costs.

Broadly yes, however we consider there is insufficient detail to assess the expected one-off and ongoing costs.

12) For individuals: Will the proposals for indirect disposals mean that you will be required to pay Capital Gains tax for the first time?

We would expect this to be the case.

Chapter 5: *Disposals of residential property*

Generally we do not see the questions in this chapter as having issues of specific concern to the AREF membership different from those in relation to other property. However we have briefly answered the questions for completeness.

13) Do you consider that it is right to harmonise ATED-related CGT given the changes proposed in this document?

Yes, this would be the most sensible option, providing it leads to simplification. However, eliminating ATED-related CGT altogether could bring about further simplification.

14) Are there any issues, risks, or complexities created by harmonising the ATED-related CGT rules in the manner proposed, and how can these be addressed?

As above, the straightforward solution may be to eliminate ATED-related CGT altogether, albeit we recognise this may introduce complexities should there be a transitional period.

15) For businesses: Will the proposals for disposals of residential property mean that your company will now be required to register for UK CT?

We would expect this to be the case.

16) For businesses: Will the proposals for disposals of residential property lead to an increase in your administrative burdens or costs? Please provide details of the expected one-off and ongoing costs.

We would expect this to be the case. We have not provided details of such costs as these measures will be of less significance to the AREF membership.

17) For individuals: Will the proposals for disposals of residential property mean that you will be required to pay Capital Gains tax for the first time?

Yes, we would expect this to be the case.

<u>Chapter 6: *Collective Investment Vehicles*</u>

Please refer to our response in the main body of the letter.

<u>Chapter 7: *Reporting and compliance*</u>

24) Do you foresee any difficulties with the reporting requirements for the seller?

Yes – there will be increased administration costs for the seller. However, it appears that there is little scope to avoid this if the measure is to be introduced.

Given that some additional administration will be required, the Government should aim to ensure that other impacts are kept to a minimum.

25) Do you foresee any difficulties with the charge on the UK group company?

We would expect the new rules to result in additional risks in respect of due diligence, which will again increase costs.

26) Do you agree with the proposal to use the normal CT Self-Assessment framework?

Yes- adding a different framework would be complex.

27) Will the proposed information and reporting requirements lead to an increase in your administrative burdens or costs? Please provide details of the expected one-off and ongoing costs.

Yes- costs will increase. Members are unable to quantify the cost before the final provisions are clear.

28) For third-party advisors: what is the best way to ensure the proposed information and reporting requirements do not lead to an undue increase in your administrative burdens or costs? Please provide details of likely one-off and ongoing costs in respect of any options or proposals.

This question is more appropriate for advisors to answer.

At the moment it is considered difficult to provide a reliable assessment of increased administration and costs due to the lack of detail within the consultation.

29) What channels and methods should HMRC use to raise awareness of this change in the law, to ensure that affected non-residents will know that they are impacted?

We would suggest that the significant impact that this change would have on investors means that awareness is already high.

Most investors in UK commercial property will have tax and legal advisors who will be informing them of these changes.