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Briefing note November 2014

UPDATE: Implementing the CGT charge on non-residents disposing of UK residential property from April 2015 - A Bombshell

As forecast in our previous briefing in April, the Government has confirmed that it is pushing ahead with the introduction of capital gains tax (CGT) on gains made by non-residents disposing of **UK residential property** from April 2015. Non-residential property will however continue to benefit from the CGT exemption for non-residents.

Hopes that the charge would be narrowly focussed on non-resident owner-occupiers of UK homes have faded. The Government conducted a consultation process earlier this year to confirm the scope and structure of the new regime (we participated in this) and published its conclusions yesterday afternoon. The document is available here.

The CGT charge will potentially apply to a wide field including businesses that hold residential property for rental (including developers who build-to-let). That said, the Government has listened to some of the many representations made and so they say they intend to tailor the charge to exempt institutional investors, limit the impact on UK taxpayers and use a collection mechanism that minimises burdens. However, coupled with the package of measures imposing CGT on corporate 'envelopes' of residential property over £500k (together with the 15% SDLT charge and Annual Tax on Enveloped Dwellings) which will continue to run in parallel, the UK tax rules applying to residential property are likely to become incredibly complex and contain traps for the unwary.

Background:

To put this in context, this is where the Government are coming from:

"The government does not believe that it is right that UK residents pay capital gains tax when they sell a home that is not their primary residence, while non-residents do not."

"We do not believe that it is right that UK companies are subject to tax on gains that they make from disposals of residential property, whereas non-residents are not."

"This change will remove the current differences in treatment of UK and non-UK residents disposing of residential property, and will bring the UK into line with many other countries that charge CGT on the basis of the location of the property [rather than the location of the seller]."

The Government says the overarching objectives for the changes will be guided by fairness, sustainability and simplicity.

The practical reality is likely to be added cost and complexity for residential real estate transactions as businesses try to get to grips with one of the most dramatic changes in the taxation of UK real estate since the introduction of CGT in 1965.

Key Points:

- The new CGT charge will apply to non-resident owners of UK residential property holding the property as an investment, for a letting business or home. It will not apply to non-resident owners of UK residential property who acquire or develop the property for sale – ie "traders" in UK real estate: they are already subject to UK corporation tax or income tax depending on the

precise facts and subject to the application of any relevant double tax treaty.

- The new CGT charge will only apply to "residential" property and not "commercial" property (such as offices, shopping centres or industrial buildings). The precise definition of what is or is not "residential" property will thus be very important. Residential property will be defined as property suitable for use as a dwelling, and communal residential property will generally be excluded from the charge. The Government has affirmed that it does not intend to broaden the scope of CGT for non-residents to non-residential property (although it should be noted that there is a risk of scope creep on a possible future change of government).
- There will be no grandfathering for existing owners of residential property who come within the scope of the charge other than CGT will only apply to gains arising after the charge comes in (6 April 2015).

Definition of 'Residential Property':

- The CGT charge will be focused on property used or suitable for use as a dwelling i.e. a place that currently is, or has the potential to be, used as a residence.
- This will include property that is in the process of being constructed or adapted for such use.
- Residential property that is primarily for communal use, such as boarding schools, care homes and nursing homes, army barracks and prisons, are to be excluded from charge.
- Accommodation used for independent living outside of a care home or nursing home environment will fall within the scope of the charge. Private residence relief will be available, if applicable, in such cases. The Government believes that this approach will ensure that non-residents disposing of UK residential property will be subject to the extended CGT charge in a fair way.
- Re: Student Accommodation - The Government has decided to create a new definition to ensure that purpose built student accommodation (PBSA) is not subject to the charge. Residential accommodation for school pupils will also remain, as a separate category outside the charge. PBSA will be defined as property that is either:
    1. a building that is purpose built (or converted) for use by students, consists of at least 15 bedrooms (which can be either standalone units or within 'cluster flats' or a mixture) and is occupied for more than 50 per cent of a tax year by students for the purpose of attending a course of study; or
    2. accommodation that is excluded from registration under the Housing Act 2004 as a house in multiple occupation by virtue of being controlled or managed by a higher or further education establishment with the management being in conformity with an approved Code of Practice for the purpose of that exclusion.
- Smaller establishments used as student accommodation, for example family houses that may have been converted or have rooms let out, will be within the scope of the extended CGT charge. The Government does not believe that it is possible or fair to differentiate these properties from other homes or rental properties owned by non-residents.
- Further information on the definition of dwelling: construction, changes in use, off-plan purchases, grounds:
    1. property that is in the process of being constructed or adapted for use as a dwelling will be in scope of the charge.
    2. Disposals of building land will be outside the scope of the extended CGT charge until such time as a residential building is under construction.
    3. Where a building is demolished, the resultant land will be regarded as building land irrespective of what structure may subsequently be constructed. The period of carrying out works to demolish a dwelling or convert it to a non-residential use will be regarded as a period of non-residential use, provided that any necessary planning consent for the works has been given and the taxpayer completes the works prior to the effective completion of the disposal. Further, where, for reasons connected with a conversion or demolition, a dwelling is unoccupied immediately prior to the works being performed, that period will also be regarded as a non-residential period. Where the works are not completed, the building will be regarded as residential during the period that the works are performed (and for the period it is unoccupied immediately prior to then).
    4. Where a change of use occurs over the period of ownership, the gain accruing on disposal will be time apportioned to reflect the time that the building was not used for a residential purpose.

5. The government has also decided that disposals of rights to acquire a UK residential property 'off plan' (before it has been constructed) will be treated in the same way as if it were a disposal of an interest in a completed property.
6. Residential property will also include land that is or forms part of the garden or grounds of a residential building.

- There will be no exemption for disposals of multiple dwellings (six or more separate dwellings) of the kind currently available under SDLT (which treats such multiple disposals as 'commercial').
- The charge will apply mainly to non-resident individuals, non-resident trustees, personal representatives of a non-resident deceased person and some non-resident companies disposing of UK residential property. The Government has recognised the concerns raised by many stakeholders about the impact of the extended CGT charge on large scale institutional investment, which is supporting much needed development and supply of housing in the UK. The Government has decided to ensure that all disposals of UK residential property made by diversely held institutional investors will not be subject to the charge. The Government will achieve this through the introduction of a "narrowly controlled company "test" which will work alongside a "genuine diversity of ownership" test. The Government says this will ensure that non-resident individuals and closely connected parties who make disposals of UK residential property will be subject to CGT, but that most institutional investors will not (see below).
- The extended CGT charge for a non-resident disposing of UK residential property will not apply to the amount of gain relating to periods prior to April 2015.The government will allow either rebasing to 5 April 2015 or a time-apportionment of the whole gain, in most cases (see below).

Indirect Residential Property Ownership

- The Government has considered how to charge gains made on disposals of UK residential property through different forms of non-resident entity.
- The Government proposes that trustees that are not regarded as UK resident should be subject to CGT on disposals of UK residential property, and so proposes to include all types of non-resident trust within scope of the CGT charge, in the same way that all trusts with UK trustees are subject to UK CGT.
- Disposals made via tax-transparent partnerships are to be taxed according to the existing rules on apportioning partnership chargeable gains to the partners, so that non-resident persons who are partners will be charged to CGT to the extent that gains are attributable to them but subject to any applicable exemption they themselves might have.
- Disposals made by a non-resident company will come within the CGT charge if that company is a "narrowly controlled company". This test will limit the scope of the extended charge to companies that are the private investment vehicles of individuals, families or small groups of individuals or families. This will deter individuals that would otherwise be within scope of this measure from transferring their interest in UK residential property to a non-resident company in order to escape the CGT charge:

1. The starting point for the test will be the existing close company test (broadly, 5 or fewer controlling shareholders), with certain modifications. In particular modifications will be made to ensure that members of a partnership are not treated as connected with each other purely because of their common investment through the partnership. It will also allow for layers of investment structures to be "looked through" in order that any diversely owned investment structure should fall outside the charge.
2. The test will ensure that the extended CGT charge will not apply to:
   (a) Any "qualified institutional investor", e.g. pension funds investing on behalf of large numbers of individuals, sovereign wealth funds and most financial institutions.
   (b) Any other non-resident company that is not itself controlled by 5 or fewer persons (including connected parties).
   (c) Any non-resident company which can only be controlled by 5 or fewer persons if at least one of those persons is a "qualified institutional investor".
3. Partnership structures will be looked through, so no special rules will be needed for LLPs.
4. For the purpose of the extended CGT charge, a "qualified institutional investor" will include:
   (a) A company (other than a collective investment scheme (CIS)) that is itself a qualifying institutional investor

(b) A CIS that would itself be exempt from the charge (see the GDO test below)

(c) A foreign pension scheme established for the benefit of a diverse range of individuals.

(d) Any fund that benefits from a general exemption from tax in the UK by reason of sovereign immunity.

5. To ensure that the charge is targeted appropriately and to limit opportunities for tax avoidance, the following rules will be introduced:

 (a) The interests of closely related family members will be aggregated when considering whether a company is controlled by five or fewer persons.

 (b) As regards “protected cell” companies, each cell will be treated as a separate company.

 (c) Arrangements intended to otherwise sidestep the control test will be disregarded.

It is presumed that such a CGT charge would apply (at the company level) should the disposal be by way of sale of shares in the relevant company although the effectiveness of such a charge may depend on the jurisdiction of the relevant non-resident entities as some double tax treaties (notably Luxembourg) could prevent such a charge arising in these circumstances.

- The Government does not generally propose to tax non-residents on disposals of shares or units in a fund (examples given are collective investment schemes (CISs) and Property Authorised Investment Funds (PAIFs)). However, to prevent use of funds for avoidance purposes, the Government suggests that in some cases a charge at fund level could be levied, and intends to introduce a genuine diversity of ownership (GDO) test so that closely held funds are subject to the charge. A CIS (including an open ended company) will be exempt provided it can show that it satisfies the GDO test. The government has decided that the existing GDO test in the UK authorised funds legislation and offshore funds rules will be replicated, subject to minor amendments, for the purposes of the extended CGT charge. The amendments will be as follows:

 1. The CIS must meet the GDO test for the shorter of i) the period for which the asset has been held or ii) at least five years prior to the disposal.

 2. Any CIS that satisfies the GDO test should be treated as a “qualified institutional investor” in any non-resident company (as well as being exempt from the charge for its own purposes).

 Further guidance on all the above has been promised in due course. In the meantime, this is likely to mean that residential property held by a Jersey Property Unit Trust with a small number of unit holders would come within the charge.

- It can be seen that pension funds will, however, be excluded from the CGT charge.

- Non-residents investing in UK residential property through UK REITs will not be subject to the CGT charge, and neither will foreign REITs holding residential property where they are 'equivalent to' UK REITs. HMRC are drafting guidance on what constitutes an 'equivalent foreign REIT'.

- The CGT charge is likely to apply to all UK residential property sold by relevant non-resident corporates, even where the value is below the £500,000 ATED/15% SDLT threshold. The ATED-related CGT charge applicable to corporates holding residential property over £2m (reducing to £500k from April 2016) - @28% - will continue to run in parallel and apply first, defaulting into the wider CGT charge where the ATED-related CGT charge does not apply (this could easily happen as the ATED-related CGT charge does not apply to businesses and is focussed on owner-occupiers). The applicable CGT rate for companies will mirror the UK corporate tax rate, currently 21% (although the expected UK corporate tax rate from April 2015 will be 20%). Non-resident companies will have access to a limited indexation allowance and group companies will have the ability to enter into “pooling” arrangements to in effect charge only gains made on disposals of UK residential property by non-resident companies and allow losses that non-resident companies incur on disposals of UK properties:

 1. The indexation allowance will allow for the effect of inflation on the costs of acquisition when calculating any chargeable gain, in line with the approach for ATED.

 2. Where companies do not belong to a group, or where no election for pooling by group companies is in place, then gains and losses will be treated in the same way for companies as they are for individuals. Losses on disposals of UK residential property will be ring-fenced, and will be able to be used to offset gains on such properties arising to

the same person in the same period, or carried forward to later periods.

3. Where several different companies within the group own UK residential property, they will be able to operate a pooling arrangement. As HMRC does not have the same powers to seek and verify information concerning company ownership that are available for resident companies, any pooling arrangement will be available only to companies that can provide clear information regarding the ownership of the companies holding UK property sufficient to establish that they are part of the same group. A group will be defined on the basis of companies that are or would be required under generally accepted accounting practices to consolidate their accounting results in group accounts.
4. Where a pooling arrangement is in place, a nominated company will be responsible for making a consolidated return of all relevant disposals during the relevant period. Relevant chargeable gains and losses arising on UK residential properties will be aggregated across the group. A 'de-pooling charge' will be levied on companies that leave the pooling arrangement, for example where the relevant company leaves the group. This will be calculated on the basis that there is a deemed disposal of UK residential property that is held by a company when it leaves the pooling arrangement.

- The extended CGT charge will take precedence over existing anti-avoidance provisions that attribute gains to UK resident members of non-resident companies. Instead, in a similar way as for ATED-related CGT, the non-resident company will be responsible for accounting for and paying the CGT that is due.
- The government appreciates the concerns that have been expressed about the administration and record-keeping for those non-resident companies that may be subject to the annual tax on enveloped dwellings (ATED). However, the government believes that the ATED-related CGT charge is an important part of the package of measures to deter enveloping of property. This charge will remain at 28% on disposals of property subject to ATED. To prevent potential double taxation, where part of the gain could be subject to both ATED-related CGT and the new CGT charge the ATED-related CGT charge will take precedence.

Non-resident Individuals

- Non-resident individuals in scope of the charge may be eligible for private residence relief (PRR). The earlier consultation document discussed possible changes to PRR and the ability to elect a person's residence for relief as an only or main residence. The government has decided to introduce a new rule to restrict access to PRR for properties located in a jurisdiction in which the individual is not tax resident. This rule will apply to both non-residents disposing of UK residential properties and UK residents disposing of residential properties located outside the UK. The rule will require that in either of those circumstances, a person's residence will not be capable of being treated as their only or main residence for a tax year unless they have resided in the property for at least 90 midnights in the property in that year (the "90-day rule"). Consequential access to PRR will then follow normal rules. Non-residents will be able to nominate that a UK property meeting the 90-day rule is their only or main residence for a tax year at the time of disposal. Access to PRR will also be available for trusts if the beneficiary is non-UK resident on the same basis.
- The annual exempt amount (currently £11,000) will be available to non-resident individuals subject to the new CGT charge, and be allowed to offset losses on UK residential property where appropriate.

General

- The Tax rate charged on non-resident individuals will be the same as the CGT rates for UK individuals, currently 18% or 28% depending on the person's total UK income and chargeable gains for the tax year.
- The Government intends that any gain arising before 6 April 2015 will not normally be subject to the extended charge. The default position will be to 'rebase' the property to its market value at 6 April 2015 so that only the gain realised over that value (after deduction of any allowable costs incurred after then) is subject to the charge. Should the taxpayer not wish to rebase they will have the option to 'time apportion' the whole gain over the period of ownership. This option will not be available if the disposal is also subject to ATED-related CGT. Taxpayers will also have the option to neither rebase nor time apportion the gain and instead to compute the gain (or loss) over the whole period of ownership.
- Losses on disposals of UK residential property will be ring-fenced for use against gains on such properties arising to the same non-UK resident person in the same

tax year, or carried forward to later years. Where a person's residence status changes from non-UK resident to UK resident, unused UK residential property losses will be transferable and be able to be used as general losses against other chargeable gains; and a UK resident who becomes non-UK resident will be able to transfer unused UK residential property losses so they become available against future UK residential property gains.

- One of the main challenges implementing CGT on non-residents is how to collect the tax. The Government's view is that a new reporting and collection mechanism is necessary but needs to be proportionate in ensuring that the regime is both robust and sustainable. The Government understands that introducing a new withholding tax is a significant change, and wants to minimise burdens where possible. As such, we are told that the new mechanism will take the form of a 'payment on account' process, rather than a 'true' withholding tax. Although the design of the process is yet to be finalised HMRC are working on the following outline:

  (a) A different process will apply to non-residents with an established relationship with HMRC via a live self-assessment record to those that do not.

  (b) However, in both cases the non-resident disposing of UK residential property will need to notify HMRC within 30 days of the property being conveyed that the disposal has occurred. There will be no obligation on those involved in the transaction to collect the tax due, but the Government expects that it is likely that they will facilitate the process and could charge a fee for their service.

  (c) HMRC will need to be notified where there is a loss, or no gains on the disposal of the property, or if any gains made are covered by an individual's annual exempt amount. The notification will also be the method by which a private residence relief (PRR) nomination is made.

  (d) Where there is an existing relationship and the disposal is not exempt by virtue of PRR, the person will also have to deliver their self-assessment return after the end of the tax year and make any payment that is due within the usual self-assessment timescales in the normal way. A person may choose to make a payment on account in respect of the disposal and, if so made, this will be shown as a credit on their self-assessment statement.

  (e) For these purposes, a live self-assessment record will not include the declaration of the disposal or delivery of an ATED-related CGT return.

  (f) A person who does not have an established relationship with HMRC, as detailed above, will be required to deliver a return for the disposal within 30 days and make payment at the same time. The return will be treated as if it were the self-assessment return for the tax year in question, with amendments being permitted within 12 months following the normal self-assessment filing date for the tax year in which the disposal is made.

Thus in summary, individuals and companies will need to report to HMRC within 30 days of the date of completion that a disposal has been made and make a payment of the tax that is due. Where a person has an existing relationship with HMRC, they will be able to make a payment as part of their self-assessment return instead.

Next Steps

Draft legislation will be published as part of the draft Finance Bill 2015. The government recognises that the extension of CGT to non-residents is a significant reform that will affect a range of people, and intends to continue to engage with stakeholders on the draft legislation and the details of how the policy will apply.

Contacts

David Saleh
Partner
UK Head of Real Estate Tax

T: +44 20 7006 8632

E: david.saleh
@cliffordchance.com

Alastair Alderton
Senior Associate

T: +44 20 7006 2917

E: alastair.alderton
@cliffordchance.com

Alex Tostevin
Senior Associate

T: +44 20 7006 2761

E: alex.tostevin
@cliffordchance.com

Edward Page
Associate

T: +44 20 7006 4784

E: edward.page
@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

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