UK Tax Alert.
Non-resident capital gains tax: Implications for the funds industry and overview of available elections

Gains realised by non-UK resident investors on disposals of interests in UK land and in certain property-rich entities are to be brought within the scope of UK tax from April 2019. However, there are to be special rules for the funds industry - which have now been published in full.

The rules are complex, but in essence will allow certain offshore funds to (in broad effect) move the tax point to the investor rather than the fund itself, or to benefit from certain exemptions. For the most part, flexibility will be offered by allowing funds to elect into the particular tax treatment they choose.

With only a few months to go until the new rules come into effect, funds and investors need to begin thinking now about which elections are available to them and the vehicles through which they invest, and the effects of those choices.

Exempt investors, in particular, need to consider their position carefully: in some circumstances it may be beneficial for them to restructure their investments or obtain additional contractual protection.

We have been analysing how the new rules, and the elections offered by them, can be used to achieve the optimum result for a number of different, commonly-seen property holding structures. We would be happy to discuss our thoughts further with you and consider how your particular requirements can be met.

If you would like further details, please get in touch.

Widening scope of non-resident capital gains tax (NRCGT) in the UK

In broad terms, from 6 April 2019, non-UK investors will be chargeable to UK tax on gains made on disposals of:

> interests in UK property (whether residential or commercial); and

> interests in UK property rich entities, where the investor has a substantial (25%) interest in that entity. An entity will be UK property rich for these purposes where 75% or more of its value derives from UK land (although
there will be a “trading exemption” if the entity holds the land for the purposes of a trade).

The new rules are intended to level the playing field between UK and non-UK investors by removing the more favourable treatment currently enjoyed by non-UK investors. In particular, under the existing rules, non-UK investors are only subject to UK tax on disposals of UK residential property and even then only on direct disposals of the land itself. This has meant that, in the past, many structures for investing in UK land have made use of non-UK investment vehicles. Such structures will now need to be revisited.

Draft legislation to implement these changes is now available (in the form of the Finance Bill that will become Finance Act 2019).

Concerns for the funds industry

The Government has acknowledged that bringing non-UK investors within the scope of UK tax creates particular problems for the funds industry. The Government considers that the concerns boil down to two key issues:

> the impact on exempt investors (such as pension funds and sovereign wealth funds) in offshore funds, where the new rules could cause them to be taxed at the level of subsidiary holdings; and

> the potential for economic double taxation when disposals are made at a lower tier of a fund structure and the proceeds are then passed up to investors.

To address these concerns, a detailed set of fund-specific provisions will be introduced alongside the widening of the NRCGT rules. There has been extensive consultation on these provisions and they are now included in the draft legislation referred to above, and summarised in an accompanying policy paper.

Fund-specific provisions

The fund-specific provisions relating to NRCGT will be contained in a new Schedule 5AAA TCGA 1992.

The table below provides a high-level overview of these rules, and how they will affect funds and their investors. The table assumes the fund in question is UK property rich for these purposes.

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<th>Treatment/election</th>
<th>Effect</th>
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<td>Default treatment as opaque (Paragraph 4, Schedule 5AAA)</td>
<td>By default, offshore collective investment vehicles (other than partnerships) will be treated as companies, and investors in such funds will be treated as shareholders in a company, for NRCGT purposes. Accordingly:</td>
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Such funds will be liable to NRCGT in respect of disposals of interests in UK property and disposals of interests in UK property rich companies.

Investors will potentially be taxable on disposals of their interests in the fund, as disposals of interests in a UK property rich company. Importantly, note that a deeming provision applies for these purposes such that investors in UK property-rich collective investment vehicles will generally be treated as having a substantial (25%) interest, regardless of their actual level of investment.

| Election for transparency | A transparency election will be available to offshore collective investment vehicles that are income tax transparent, excluding partnerships (for example unit trusts).
| (Paragraph 8, Schedule 5AAA) | Funds making the election will be treated as a partnership and investors in such funds will be treated as partners in a partnership, for all capital gains purposes. Accordingly:
| | • Such funds will not be taxable entities.
| | • Investors will potentially be taxable on disposals by the fund of interests in UK property and interests in UK property rich companies.

| Election for exemption | An exemption election will be available to certain UK property rich offshore collective investment vehicles (or in respect of UK property rich subsidiaries of certain transparent collective investment schemes) which meet a number of conditions. The conditions seem to be designed to stop the election being used by most narrowly-held corporate vehicles. Where the exemption applies:
| (Paragraph 12, Schedule 5AAA) | • The fund/subsidiary will remain a person for tax purposes, but benefit from an exemption from capital gains tax on direct and indirect disposals of UK land.
| | • Subject to the “pass-through” exemption discussed below, investors will be unaffected by the exemption, and so will remain potentially taxable on disposals of their interests in the
fund, as disposals of interests in a UK property rich company.

- “Deemed disposals” (with complex timing provisions) also arise for investors in certain circumstances, including where investors receive amounts of a revenue nature from the relevant fund that represent value derived from a direct or indirect disposal of UK land, or where the election ceases to have effect (e.g. because the relevant fund ceases to meet the conditions for exemption).

The exemption (or a proportionate exemption) also extends to disposals by other entities in which the exempt fund/entity has a 40% or more interest.

| “Pass-through” exemption (Paragraph 33 Schedule 5AAA) | A non-CIV entity which is wholly owned by qualifying institutional investors, certain life insurance companies or funds/companies exempt under a paragraph 12 election (see above) can benefit from a limited “pass-through” exemption. This is primarily aimed at corporate ‘blockers’ or other wholly owned SPVs via which such exempt investors invest.

Broadly, this means such an entity will be exempt from capital gains tax on any gain accruing on disposal of an interest in a relevant fund (being a collective investment scheme that has made an election for exemption under paragraph 12, discussed above). However, the fact that this exemption is only available where there is an investment in a fund or company that benefits from an exemption under paragraph 12 means its use is fairly limited.

What next: choosing the right elections

Overall these changes represent a fundamental shake-up of the tax rules applicable to investment in UK land. Going forward, they mean non-UK funds investing in UK land will have a number of structuring options available, depending on their own investor base and asset profile. This flexibility is to be welcomed. However, it will be clear from the brief summary above that the new rules are complex. More importantly, funds and investors should be aware they may not always offer a complete solution and in some circumstances restructuring of investments may be required.
Our suggestion is that:

> Funds and investors begin now with an information gathering process, to establish how they are invested in UK land, and the tax profile of their investor base.

> The investment structures identified will then need to be considered alongside the new rules, to understand (i) what elections are available, and (ii) the effect of those elections on the fund and its investors (at all levels). Particular complications may arise for structures which include entities which are not collective investment vehicles (as defined in the legislation) and entities which are not UK property rich. Exempt and institutional investors will also be concerned to ensure that they can fully benefit from their exempt status.

As noted above, in some circumstances these difficulties may necessitate a rethink of the investment structure. It is possible, for example, that use of a REIT would be a preferable alternative to existing investment vehicles.

> Funds and investors will also need to consider whether any contractual protection is required, for example to ensure that expected exemptions are available or that the benefit of any exemptions flows through to the appropriate investor.

> Finally, there will be a number of compliance aspects to consider. Each of the elections outlined above has different requirements, some of which are ongoing.

Unfortunately, there is an element of time pressure to this process in view of the commencement date for the new rules: 6 April 2019. Although double tax treaties may offer protection in limited cases for slightly longer, this is not expected to be a long-term solution (for example, HMRC has already announced that it is renegotiating the UK-Luxembourg double tax treaty).

We would be happy to discuss this further with you and assist with these steps as necessary.