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CREFCE response - Taxing gains made by non-residents on UK immovable property (published 22 November 2017)

Introduction

The Commercial Real Estate Finance Council (**CREFC**) Europe is a trade association promoting a diversified, sustainable and successful commercial real estate (**CRE**) debt market in Europe that can support the real economy without threatening financial stability. Our core membership includes lenders and intermediaries who help connect capital seeking the risk and returns of CRE debt with real estate firms seeking finance.

We are grateful for the opportunity to comment on the Consultation Document "Taxing gains made by non-residents on UK immovable property published by HM Treasury (**HMT**) and HM Revenue & Customs (HMRC) on 22 November 2017 (the **Consultation**).

In preparing our response, we have had the benefit of reviewing the submission to be made by each of the British Property Federation (the **BPF**), which represents the views of businesses in the UK that own, manage and invest in property, and the Association of Real Estate Funds (**AREF**), = representing real estate funds.

We share with the BPF their disappointment that the proposed extension of capital gains tax (**CGT**) to non-UK resident owners of UK real estate was not afforded a policy consultation. Instead stakeholders are being allowed only a limited technical consultation on the proposals, with limited time thereafter to comment on the detail of draft legislation – some of which, particularly in connection with indirect disposals, has the potential to be particularly complex: on the basis of the announced timetable, the legislation will be before Parliament as part of a Finance Bill within only a few months of first being published in draft form.

We also share the BPF's concerns (as reflected in the "Key Concepts" section of their submission) as to the number and extent of changes to the tax system that impact real estate in recent years. Like the BPF, we ask that the government now look to provide a period of stability in the tax system. Recent changes to UK tax – such as loss reform, corporate interest restrictions and the move to bring non-resident corporate landlords into corporation tax – will have a material impact on real estate investors' business models – and as a result have the potential to impact the terms on which finance may be available: they, and other parties, need time to adjust.

We set out our key comments below and address specific Consultation questions in the Appendix.

Background

The functioning of business in the wider economy relies on investment into CRE. CRE accounts for at least 25% of the UK capital stock, and the importance of CRE as collateral for borrowing is illustrated by research suggesting that a 10% fall in UK CRE prices is associated with a 1% decline in firm investment.[1]

Investment into CRE is critical for any economy. By providing much of our built environment, the CRE industry represents a critical component of the real economy, delivering important socio-economic benefits to communities as well as providing the accommodation businesses need.

[1] See A Vision for Real Estate Finance in the UK (available at http://www.ipf.org.uk/asset/0D24F055-38E6-419F-8E117665F4F47854/), Appendix 1 and footnote 123, citing ONS and Bank of England data and analysis; and research by Bahaj, Foulis and Pinter (2016), cited in a February 2018 speech by Alex Brazier, Bank of England executive director for financial stability strategy and risk (see https://www.bankofengland.co.uk/-/media/boe/files/speech/2018/market-finance-and-financial-stability-will-the-stretch-cause-a-strain-speech-by-alex-brazier.pdf?la=en&hash=0B85A08721D8D3748EFA403D2F837B0EA8FC463F, footnote 4).

As a capital intensive and long-term business often involving very large, valuable and illiquid assets, CRE is dependent on the ready availability of credit. This dependency is driven principally by the very different risk and return expectations (and hence cost) of different types of capital. The CRE finance industry therefore plays an important role in supporting CRE investment and, as a result, the wider economy, by providing the debt finance that helps fund capital investment in real estate.

CREFC Europe is the voice of the CRE finance industry in Europe, representing banks, insurance companies, fund managers, and others who provide or intermediate the provision of debt to real estate businesses, as well as advisers, consultants and others with a stake in this sector.

Key comments

The need for tax stability

As the BPF highlight in their response, almost every fiscal event in recent years includes measures that impact real estate investment – some targeted specifically at real estate, whilst others, such as the recent corporate interest restrictions, although applicable to taxpayers generally and conceived primarily to target multinational corporations, have a disproportionate practical and economic effect on CRE investment because of the role debt plays in funding it.

Generally, investment in real estate is a medium- to long-term commitment. Business models generally look ahead several years – and those models underpin both equity investment and the financing decisions made by lenders. Every time the tax rules change significantly, the assumptions that underpin business models need to be re-drawn – and that can not only impact the expected (after tax) return for equity investors, but potentially the cash flow models that are used by lenders when making their financing decisions - and as a result risk impacting the ability of borrowers to comply with financial covenants in loan documentation. The changes to the tax treatment of non-resident owners of real estate announced at the November 2017 Budget are clearly significant changes in a UK context – and only one (the move to CT) had been trailed as likely beforehand.

Stability is critical to encourage investment, particularly long-term investment. We therefore ask that:

- The government in future consults on substantive policy changes, and not only on the technical details, so as to ensure policy decisions, as well as their implementation, proceed based on a full appreciation of the commercial context and possible unintended consequences;

- Where (as in the case of the present proposals) there has not been any prior consultation on substantive policy changes, the government takes the time necessary to get implementation right, rather than rushing to meet an arbitrary deadline and then having to clarify or correct new rules with the ink barely dry; and

- After a lot of substantial and often unexpected changes to tax rules over the last few years, the government should pause to allow the industry the time to absorb and adapt to those changes, and for their consequences (including any unintended consequences that may need correcting through amending legislation) to become clear. Committing to a period of "uneventful" budgets when it comes to real estate would be good for industry and government alike.

The need to ensure that the measures work, technically and practically

Although it is relatively straightforward to identify how the extension of CGT to direct disposals by non-residents will work, the same cannot be said about the proposals in Chapter 4 of the Consultation on Indirect Disposals. Relevant issues are discussed, but there is very little detail on how the measures will work in practice – particularly where the indirect investment is made through several layers (and forms) of entity. This is even more of an issue in relation to CIVs, as Chapter 6 (and the comments of both the BPF and AREF) affirm: in certain cases, the Consultation simply states that "consideration will be given to whether changes will be made" without giving any indication of the types of change that may be considered.

Existing real estate structures almost invariably make use of intermediate holding entities between the ultimate investors and the properties. Real estate lenders such as our members will typically require the use of intermediate holding entities for commercial reasons: this links to ring-fencing the asset being financed and is intended to ensure that they have access to multiple levels of easily enforceable security (ie asset level security as well as a single share pledge allowing enforcement over the shares in the company with the property business) in the event of a default. This can be even more important when debt is provided by both a senior lender and a mezzanine lender. It is therefore crucial that the new rules are able to work efficiently for indirect disposals without creating multiple layers of tax or (as referenced below) disadvantaging ultimate investors which would benefit from exemption if they were to make a direct disposal.

For these rules, the devil will be in the detail – and the first sight of that detail is unlikely to be until July (as per the revised Tax Policy Framework). That legislation will be re-published as part of Finance Bill 2017-2019 after the Budget in late 2018 – and will take effect less than 5 months later. With "some aspects of detailed policy design that are still open" (as per Chapter 9), the timetable is ambitious. This is not a business-friendly or deregulatory approach to policymaking.

Given that the changes announced reverse a policy approach to CGT that has been in place for over 50 years, like the BPF, we ask that the government consider giving both itself and stakeholders an additional year to produce legislation (and related guidance) that is clear, effective and works. Linked to the point we make above about stability, it would be preferable to delay the initial implementation timetable, rather than introduce legislation which then has to be amended in the next Finance Bill. The government has an unhappy record of rushing in new rules that need to be clarified or corrected immediately after being enacted. .

The need to ensure fairness within the measures: particularly in relation to preserving exemption for tax exempts regardless of how they invest

The real estate finance market needs transactions – the debt follows the equity and performs a particular role given the different risk (and return) expectations of investors.

A significant number (by value) of real estate investors are tax exempt institutions – such as pension funds, sovereign wealth and life assurance businesses, whose long-term approach is well-suited to this asset class. The importance of such investors was not only recognised in the changes to the REIT rules in 2012, but also in the recent reform of SSE. As both the BPF and AREF identify in their comments, many such investors choose to pool their capital and so invest via collective investment vehicles, allowing larger assets and portfolios to be funded. If the effect of the changes is that such investors lose their tax exemption because of how they structure their investment, such investors could easily decide to invest elsewhere.

We therefore agree with the BPF and AREF that the changes to non-resident CGT need to provide reliable tax transparency for such investors – rather than risk their tax exempt status being jeopardised purely because of the form (not substance) of their investment in the UK.

We remain at your disposal should you have any questions or require further details.

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Appendix: the Consultation questions s

Scope of the Measure

Question 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 specific issue arises in relation to the basis on which a non-resident is to be brought into charge - given that the Consultation suggests this will be by reference to ownership of a particular asset, consideration will need to be given to ensuring that the non-resident is able to benefit from "normal" CGT provisions that to date are only available to UK residents or to non-residents within section 10B (see for example s171(1A).

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

Paragraph 2.8 of the Consultation states that rebasing will be required at either 1 April 2019 (for companies) or at 6 April 2019 (for other persons). We note that, as at April 2019, non-UK companies that own UK real estate will be within the charge to income tax (the Responses Document to the Consultation "Non-resident companies chargeable to income tax" (the **Response Document**) confirms that the government does not propose to bring non-resident corporate landlords into the charge to corporation tax until 6 April 2020). This would therefore suggest that the same date should apply for rebasing for all non-resident holders of real estate, regardless of form(i.e. 6 April 2019) as all such investors are subject to the same tax treatment at that time. See also our answer to question 5.

If the government's current stated intention of maintaining the NRCGT computational rules changes (see paragraph 2.16 of the Response Document) consideration should be given to how the transition between NRCGT and "normal" CGT is to be effected.

In relation to rebasing itself, the government should consider including in guidance its views on what type of evidence from a non-resident would in general be accepted as demonstrating market value on that date: this is particularly relevant to indirect interests (for direct holdings, there is recent experience following the introduction of NRCGT). In this context, we agree with the comments made by AREF in its submission relating to the practical issues around requiring valuations as at April 2019.

We also agree with the comments made by the BPF that the rebasing options for direct and indirect interests in real estate should be the same.

Direct disposals

Question 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?

Given the stated policy intention of creating a level playing field, we agree that as a general matter the same computational rules should apply. This is however subject to the government's further thinking on maintaining the computational rules for residential property within NRCGT (as referenced in the Response Document): if retained, these should apply to all relevant non-residents.

We note however that, depending how the charge to CGT is imposed, the rules relating to transfers within a group (s171 Taxation of Chargeable Gains Act 1992 (**TCGA**)) will need to be amended, as s171(1A) TCGA only extends to non-resident companies within section 10B TCGA (companies with a UK permanent establishment): although these provisions are not within Chapter 2 and Chapter 3 TCGA, they are relevant to determining allowable expenditure.

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

See answer to question 1: in particular, changes may be needed to the grouping rules and other provisions that now apply only to UK residents and companies within section 10B TCGA. In addition, the interaction with the rules in Schedule 7AC needs to be considered carefully, particularly in relation to the (new) relief in paragraph 3A.

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

Given the intention that non-resident corporate landlords remain within income tax until 6 April 2020 (see answer to question 2 above), we would query whether it is sensible to require such non-resident companies to register for corporation tax prior to that date because of these measures. With the repeal of the indexation allowance, allowable expenditure for CGT should be the same whether a taxpayer is liable to CGT or corporation tax on chargeable gains and therefore, in the event of a disposal between 6 April 2019 and 5 April 2020, there should be no difference (in terms of tax in the event of a disposal) if corporate property owners remain within CGT (and not corporation tax).

As the government itself recognises, companies need sufficient time to adjust to the CTSA system (see paragraph 2.7 of the Responses Document to the Consultation "Non-resident companies chargeable to income tax") – and as a result to require corporate landlords to register for both income tax and CTSA in parallel imposes an additional administrative burden on businesses for no obvious Exchequer benefit.

Question 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.

Not applicable – though we would note that the need to comply with UK tax rules to which such companies were not previously subject will result in additional compliance costs for the business as a matter of course.

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

Not applicable.

Indirect disposals

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

We agree with the comments of the BPF on the proposed charge on indirect transactions.

In terms of the property rich test, we note that, under SSE, around 80% of a company's activities need to be trading for exemption to be available (given the meaning of "substantial"). It would be consistent if the property rich-ness of a company for this charge were also determined by reference to a similar "substantial" (>80%) test: i.e a company is property-rich it its assets do not to a substantial extent include non-UK property business assets.

Further, whilst we recognise the need to aggregate related parties, we are concerned that adopting "acting together" rules within 465(3) TIOPA – particularly in relation to interests in a partnership – will make the rules challenging to apply in practice. These are very broad provisions, and the guidance available currently is limited in its application to the most straightforward of ownership structures only.

Question 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?

No comment.

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

Not applicable.

Question 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.

Not applicable - though again we would note that the need to comply with UK tax rules to which such companies were not previously subject will result in additional compliance costs for the business as a matter of course (costs here including the need to take professional advice on the broad-ranging attribution rules simply to identify whether or not the business is within the scope of the rules).

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

Not applicable.

Disposals of residential property

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

We agree with the comments of the BPF and AREF: any simplification of these tax rules (including repeal of ATED) is welcome.

Question 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?

No comment.

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

Not applicable.

Question 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.

Not applicable.

Question 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?

Not applicable.

Collective Investment Vehicles

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

We agree with the comments of the BPF.

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

Not applicable.

Question 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.

Not applicable.

*Question 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 propert*y?

We agree with the comments of the BPF and AREF in relation to ensuring that tax exempt investors in UK real estate are not adversely affected by the changes.In this context, existing real estate structures almost invariably make use of intermediate holding entities between the ultimate investors and the properties. Real estate finance is generally provided on non-recourse terms, and the use of such holding structures enables the asset being financing to be ring-fenced from other activities/assets of the investors. In particular, the use of one or more intermediate holding vehicles provides lenders with access to multiple levels of easily enforceable security in the event of a default (i.e. asset level security as well as a single share pledge allowing enforcement over the shares in the company with the property business). This is especially important where debt is provided at both senior and mezzanine levels. The new rules must not therefore disadvantage ultimate investors which would benefit from exemption if they were to make a direct disposal.

Question 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 comment.

Question 23: Do you have any further comments on the taxation of gains on non-residential UK property?

We consider that the timetable for introducing these changes, particularly in relation to indirect disposals of UK real estate, is ambitious given the technical complexity involved. We would therefore ask that the government consider deferring the introduction of these measures until April 2020 (to coincide with the introduction of the other changes to the tax treatment of NRLs). Doing so will provide government with the time it needs to get the necessary legislative changes right, and taxpayers and other affected parties time to understand and prepare for them.

Reporting and compliance

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

No comment.

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

No comment.

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

No comment.

Question 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.

See answer to question 6.

Question 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.

We share the concern expressed by BPF as to the effect of this suggestion on those involved in advising on real estate transactions.

There needs to be clarity as to which advisers need to report. In this context, any obligation to report should be only on those advisers directly involved on behalf of the parties to the disposal that needs to be reported. At paragraph 7.13.2, the Consultation refers to advisers who receive fees for services “relating to a transaction”. It needs to be clear that t “relating to” means direct involvement in the transaction, rather than involvement in an ancillary way, such as in the production of a technical due diligence report required by the purchaser or its lender. Similarly, the sale of a property may involve repayment or prepayment of existing debt and/or the consent of a lender – this would involve the lender possibly receiving a prepayment or other fee and/or appointing advisers to act on its behalf on the repayment. Neither the lender nor its advisers should be within the scope of any reporting obligation under these rules.

If unnecessary compliance cost for business (as well as general uncertainty) is to be avoided, it is important that the precise scope of any reporting requirement is clear on the face of the legislation rather than drafting the obligation broadly, and then relying on guidance to set out who HMRC consider this obligation applies to in practice.

Any reporting measures also need to take due account of legal privilege.

Question 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 welcome HMRC's acknowledgement of issues around taxpayer awareness of changes – and with that the need to consider alternative ways of notifying affected persons (many of whom may have no tax nexus with the UK). This is particularly relevant given the wide range of affected investors, from sophisticated institutional investors to individuals with no other connection to the UK. Given that international dimension, the government should be sensitive to the effect that the way this is handled could have on the perception of the UK as an investment destination post-Brexit.

For existing owners of direct interests in real estate who may already be registered with HMRC for income tax or ATED, we assume HMRC will be contacting them directly in advance of the changes (and will update the relevant returns to reference the need to report any disposal). Given the need to report transfers of UK land to the Land Registry and/or HMRC in relation to SDLT, it may also be helpful for official correspondence from such agencies to highlight that a future disposal may have CGT consequences.

For indirect owners, any notifications should reference where clear guidance can be found on the 25% condition is met, to minimise the need for investors t to spend unnecessary time and cost to determine, in many cases, that they are outside the scope.

Given recent tribunal cases relating to (late) NRCGT returns arising from awareness issues, we would ask the government to be realistic in working out its policy in relation to penalties for non-compliance due to lack of awareness – particularly in the first few years following the changes to CGT coming into effect.