AREF

BPF

BRITISH PROPERTY FEDERATION

By email: capitalgains.taxteam@hmrc.gsi.gov.uk

20 June 2014

Dear Sir/Madam

Government consultation: Implementing a capital gains tax on non-residents

Introduction

The British Property Federation (BPF) is the voice of property in the UK, representing businesses owning, managing and investing in property. This includes a broad range of businesses comprising property developers and owners, financial institutions, corporate and local private landlords and those professions that support the industry.

The Association of Real Estate Funds (AREF) represents the UK unlisted real estate funds industry and

We welcome the opportunity to respond to the government's consultation on the implementation of a capital gains tax for non-resident investors in residential property.

General comments

We understand the government's motivation in bringing forward proposals to equalise the capital gains tax treatment of residents and non-residents. The current position is admittedly anomalous in comparison to other countries and is arguably unfair towards UK residents.

That said, the current system of capital gains tax has been in place for almost 50 years and virtually all of the investment by global capital in the UK's built environment has taken place on the basis that no tax arises on capital gains from disposals of UK assets. Changing this situation could have a direct and negative impact on the investment appraisals carried out by global investors who are looking to put money into UK residential property.

Of particular concern is the impact these proposals could have on institutional investment in the PRS and build to rent sectors. By introducing several changes to the taxation of residential property in quick succession (ATED, new rates of SDLT, now the CGT changes) the government risks changing the viability of such investment at a time when we can ill afford to lose out on it. The pace of legislative change also risks eroding the UK's reputation for political stability – one of the main attractions of the UK as an investment destination.

The potential scale of investment in the UK's residential market by overseas investors should not be underestimated. There are a number of recent or planned schemes where overseas investors have committed substantial amounts of investment capital which have contributed significantly to the UK's housing stock. Some of these (potentially totalling c. 25,000 units) are set out below:

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Although we understand that these proposals are not aimed at widely held institutional investors, there is a risk that they could be caught unless careful attention is paid to the scope of the new tax. The scope must recognise the variety of ownership structures used in real estate investment and include a mechanism for 'looking through' multiple tiers of a structure to assess the status of the ultimate investors.

Lastly, given the level of concern and uncertainty that these proposals have caused among overseas investors in residential property we would welcome a statement from Government reasserting that residential investment through widely held investment structures is not the target of these measures.

Executive summary

- **We appreciate the government's desire to introduce greater fairness and simplicity into the tax system.** However, we are concerned about the potential unintended consequences of the proposals set out in the consultation paper. In particular, we are worried that the proposals could discourage overseas institutional investment into the Private Residential Sector (PRS), which has a key role to play in solving the UK's housing crisis.

- **We are therefore pleased that the government recognises the need to carefully scope** the proposed extension of CGT in order to avoid deterring large scale overseas investment in the PRS. However, in our view the way in which 'widely held' investment vehicles are identified must look through holding structures to identify the ultimate investor. Additional thought also needs to be given to the definition of "residential property", especially with respect to purpose-built student accommodation and social housing.

- **A system of self-reporting of capital gains is in our view better than collection through a withholding tax.** It would be fairer in terms of treating residents and non-residents equally and less disruptive of property transactions.

- Finally, **the interaction between an extended CGT and the existing ATED CGT** is likely to be extremely complex and administratively cumbersome. For the sake of simplicity, ATED CGT should be abolished.

Detailed responses to the questions raised in the consultation paper are included at **Appendix 1**.

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

Yours faithfully

Appendix 1: Responses to consultation questions

General comments

The UK's housing crisis

It is widely recognised that the present housing crisis in the UK is a result of insufficient new housing having been built in recent decades. The government has recognised that this needs to be addressed not just by building new homes for sale, but also by increasing the stock of private rented sector (PRS) properties. Indeed, the creation of a taskforce whose specific remit is to kick-start institutional investment in the sector is evidence of the priority that the government ascribes to encouraging large scale institutional investors into this sector.One of the more exciting developments in this area is the prospect of new building specifically designed and destined for the rental market ('build to rent'). The government has also committed seed funding for this purpose.

The PRS has historically been a difficult market to persuade investors into, due to the lack of good existing stock, the relatively low net yields compared to commercial property, and the high management costs involved. However, some investors have begun to be attracted to this market by its potential for stable and sustainable income and for long term growth. Many recognise that, in a market traditionally focused on owner-occupiers, building new stock is the best way to create a new investment product ('build to rent'), but this market is in its infancy at present. Much of the interest so far has been from some of the largest international pension funds and sovereign wealth funds from around the world, and they have needed to team up with domestic developers and property managers with the expertise to deliver and manage the product.

It is therefore particularly unfortunate that these tax proposals have been brought forward at this point. Global capital is highly mobile and very particular. As such, any change to the total return on a given investment can easily change the decision on whether or not an investment is made. The change in tax treatment could result in planned investment in UK residential property being transferred to a different asset class in the UK, or just as likely being lost to the UK all together.

Fairness

The government has made it clear that the main driver behind the proposals is a desire for greater fairness regarding the taxation of capital gains, which currently does not apply to non-residents. However, in extending the tax to non-residents it is only fair that the compliance burden and payment obligations are as similar as possible to those which apply to UK residents. Any reliefs (such as PRR and indexation) which currently apply to residents should also apply to non-residents. We set out how this might be achieved in our responses to questions 14 to 16.

ATED CGT

Retaining the CGT element of ATED after the proposals are introduced will lead to considerable confusion as one set of CGT rules will apply to a particular class of residential property and a different set of CGT rules to all other residential property. Property may move into and out of each regime depending on its use at any point. While we understand the purpose of the ATED CGT charge was to discourage the use of corporate entities, we consider that this is already achieved by the annual ATED charge and the higher rates of SDLT. In order to support the government's stated aim of introducing the proposals in a way that minimises complexity, the CGT element of ATED should be abolished or subsumed into the new rules.

De minimis limit

No capital gains tax should apply where a property is disposed of that contains only a small element of residential space (e.g. an office building with a caretaker flat). Rather than trying to define what this covers, we would recommend that in such cases a *de minimis* threshold should be applied (of say 10% of the floor space or value of the property) and tax should only arise where the residential element exceeds that level.

Q1: Would an exclusion of communal property from the scope of the new regime result in any unintended consequences?

We agree with the approach to this exclusion. Provided the scope of the charge is clearly defined and meets Government's policy objectives, there should be no adverse consequences of excluding certain forms of residential property, particularly if the excluded properties are those that the Government wish to encourage investment in.

Q2: Are there any other types of communal residential property that should beexcluded from scope?

Currently, halls of residence attached to an institution are proposed to be excluded from this tax. Although traditionally halls of residence were on the university campus and/or managed directly by the university, there are a growing number of independent student accommodation providers setting up large scale purpose built student accommodation (PBSA) in cities, not attached to a specific university. Given that they effectively provide the same service (i.e. that of accommodating students in higher education), we would recommend that large scale PBSA follows the same treatment of traditional halls of residence, and are exempt from the charge.

We would recommend using a broad definition of student accommodation, such as the SDLT definition, in order to cover the variety of forms of PBSA available. For example, we would propose that the following types of overseas-owned accommodation should be excluded from the CGT charge:

(i) halls of residence attached to an institution (per the consultation), and
(ii) residential accommodation used for students (per the SDLT definition for student accommodation, FA 2003, section 116)

In order to ensure that this broad exclusion is not open to abuse by normal homes being let to students, we would suggest adding one or both of the following safeguards for disposals of properties within limb (ii):

1. The exclusion would not be available to any property which has a C3 or C4 class of planning permission (i.e. traditional family homes). **See Note 1**.
2. The exclusion is only available where 6 or more units are disposed of in the same transaction (adopting an SDLT concept in FA 2003, section 116(7)). **See Note 2**.

Note 1: Planning permission

PBSA tends not to be classed as either C3 or C4 whereas most ordinary dwellings (although admittedly not all – for instance some large houses in multiple occupation) will fall within one or the other.

That said, there is some concern among our members over using planning classes to differentiate between properties for tax purposes as this is not consistent with how other areas of tax legislation identify types of property. In addition, we understand that there is inconsistency with how planning classes are applied in practice across the UK.

Therefore, we would recommend using the language and definitions used to describe C3 and C4 dwellings per the Town and Country Planning (Use Classes) Order 1987, rather than refer to the class names themselves.

Note 2: Scale

One of the main differences between traditional houses and PBSA is scale. PBSA is generally designed to house tens if not hundreds of students in a single building and hence we would propose that transactions where 6 or more units are sold would indicate (but not necessarily establish) a sale of PBSA. In order to improve the effectiveness of this safeguard, this threshold could be increased to sales of perhaps 10 or more units. Alternatively, the relief could only be available where the units which are sold are part of the same building.

Other defining characteristics of PBSA

Typical characteristics which would indicate that accommodation is a hall of residence or PBSA rather than an ordinary dwelling could be outlined in guidance. A selection of potential indicators are listed below:

- They are purpose built or purposely adapted for use by students.
- They are larger in scale than normal houses, i.e the entirety of the accommodation block or building will typically sleep over 100 students (often split out into 'cluster flats').
- They are rented out on contracts of less than a year.
- There are communal facilities e.g. shared kitchen, living room, laundry etc.
- The individual units or cluster flats are not normally sold individually; indeed it is more typical for the whole block to be sold together.

Q3: Are there any particular circumstances where including non-resident partners in scope of the charge might lead to unintended consequences?

The most significant unintended consequence of the measures set out in the consultation paper is the potential impact they could have on overseas investment in the UK's nascent PRS and build to rent sector.

Much of the recent interest in large-scale investment in these areas has come from overseas institutions. Indeed in our introduction we set out how approximately 25,000 homes in and around London alone are being funded by overseas capital – and we are hopeful that this is just the beginning. Changing the economics of such investment through the introduction of capital gains tax risks cutting off that investment before it properly gets going.

Bearing in mind the relatively modest revenue that the measures are predicted to raise for the Exchequer, it seems risky to introduce them without thinking carefully about how they are targeted. We therefore very much welcome that overseas pension funds, SWFs, REITs, widely held funds and charities are to be exempt from the scope of these measures.

However, there are other widely held investors (such as listed real estate development/investment companies) willing to deploy significant amounts of capital in UK residential property who may be deterred by the proposed measures. For instance, the two main overseas participants in the Battersea Power Station project would be subject to CGT on their UK investment assets under the current proposals. We understand the government's desire to achieve parity of CGT treatment between UK residents and the overseas equivalents, but are concerned that this parity might come at a high cost.

Accordingly, we recommend that all widely held investors benefit from the exemption proposed in the consultation paper for overseas pension funds, REITs et al. Our response to Question 5 sets out how this could be achieved.

Q4: Are there any particular circumstances where including non-resident trustees in scope of the charge might lead to unintended consequences?

Please see our response to Question 3.

Q5: Is a genuine diversity of ownership (GDO) test an appropriate way to identify funds that should be excluded from the extended CGT regime, and to ensure that small groups of connected people cannot use offshore fund structures to avoid the charge?

Background

As alluded to in our response to Question 3, we understand it to be government's intention to provide an exemption for any non-resident investors who would be exempt if they were the equivalent type of UK investor. However, we think that the policy needs to be broader if it is not to have a malign effect on large scale investment in the UK's housing stock by overseas institutions.

Firstly, the regime needs to be designed to ensure that the sorts of vehicle actually used by these investors (as opposed to the ultimate investors themselves) are not caught by the tax.

Secondly it needs to recognize that the vehicles used by investors of all sorts will be many and varied, and may not always be the equivalent of an Authorised Investment Fund or other exempt body. It would make more sense therefore to provide an exemption for any vehicle by reference to tests which ensure that it is widely held or owned by institutions which are themselves widely held.

Typical real estate investment structures

Large scale and institutional investment into real estate, particularly from outside the UK, is often structured via a joint venture ('JV') or co-investment structure of some description as such investors more often than not will co-invest alongside a specialist UK-based manager of residential property. These structures will vary in complexity according to the profile of the ultimate investor, but one of their main aims is to ensure that investors are taxed as if they had invested in the underlying property assets directly.

Therefore – and as has been articulated to government at various meetings during the consultation process - while we appreciate that pension funds, REITs, SWFs and widely held funds from around the world are explicitly intended to be exempt from this tax, they would often not be able to benefit from this exemption as the proposals are currently envisaged. That is because any disposal of a property would be carried out by the JV/co-investment vehicle itself or a special purpose vehicle (SPV) owned by that JV/co-investment vehicle.

For this reason, it is important that any test to determine whether the disposal of a property is chargeable to CGT should consider the nature of the ultimate investor(s) in an investment structure. The investors that are currently intended to be exempt as we understand them include widely held funds, pension funds, charities, sovereign wealth funds and REITs. We consider that the exemption should be extended to any widely held vehicle to ensure that we capture all potential institutional or large scale investment opportunities including investment from insurance/life companies and listed companies.

As these entities are widely held, with the appropriate safeguards in place, this should not create an opportunity for avoidance by small groups of private investors. In addition, this would ensure that we continue to encourage investment from all large scale and institutional investors around the world.

Appropriate tests to achieve exemptions for widely held structures:

As noted above, it is vital that a mechanism exists for 'looking through' the various levels in an investment structure to identify the ultimate investors and ascertain whether they are diversely owned.

We consider that two tests are required to identify widely held structures. The tests we have in mind already exist in the legislation and can be adapted for these purposes with minimal adjustment. This will maintain the simplicity of the tax legislation by using concepts that users of the legislation are already familiar with. As long as an entity disposing of UK residential property is able to meet either of the two tests it should be considered widely held and therefore not within the scope of the tax.

Genuine Diversity of Ownership ("GDO")

The consultation paper suggests the use of a genuine diversity of ownership ("GDO") test, in line with the test already applied to UK authorised funds for tax purposes. We consider that this is a sensible approach for equivalent overseas funds. The test ensures that the units of the fund are marketed widely to attract a large number of investors. This test will primarily be suitable for open ended funds whose investor base can change on a daily basis.

Link to legislation:
The Authorised Investment Funds (Tax) (Amendment) Regulations 2009, SI2009/2036

Close company rules amended to include the REIT diversely owned test

The close company rules ensure that where five or fewer persons control a company, that company would be considered 'close' i.e. not widely held. This would be a suitable concept to start from for determining whether closed ended vehicles (including special purpose vehicles and entities that sit at various levels in an investment structure) are widely held.

The reason for this is that the close company rules 'look through' investment structures to the status of the ultimate investor, ensuring that these can benefit from exemption from CGT where appropriate. An added benefit of using these rules is that the legislation is widely understood.

However, an adaptation to the close company rules would be required to ensure that non-corporate widely-held institutional investors are adequately exempted. That is because the rules don't currently take account of non-corporate entities like pension funds.

Fortunately, this adaptation has already been developed. The REIT legislation introduced in FA 2012 provides that where a REIT would be close but for the fact that one or more of the five or fewer persons is an "institutional investor", the close company test will not apply. We consider that this

legislation could be easily adapted for these purposes to create the necessary protections. The REIT legislation lists the various entities which are deemed to be institutional investors, including pension funds, insurance companies, authorised funds, limited partnerships that are collective investment schemes etc. *Links to legislation:* The Close Company rules (section 439, CTA 2010) REIT diversely owned test (section 528, CTA 2010) **Impact on partnerships** Partnerships are commonly used for real estate investment; therefore it is important that we consider the impact of any new legislation on partnership vehicles. In this case, we do not think that the treatment of partnerships would change significantly where they are tax-transparent. Currently, it is necessarily to apportion profits and gains to the partners in a transparent partnership and tax them according to their personal tax characteristics. The profits and gains would still be apportioned and any overseas individuals and closely held companies would be taxable on gains on residential property. The same exemptions for diversely held entities as suggested above would also need to apply where they invested through a partnership.
Q6: Are there any practical difficulties in implementing a GDO test?
As noted above, the most important aspect of any test to determine whether a disposing entity is widely held is the ability to 'look through' investment structures to the status of the ultimate investor. Structures often have multiple tiers for valid commercial and regulatory reasons and the test must be able to look through all of them. It would be wrong to imposing a limit on the number of tiers that can be looked through. We consider that the close company rules as amended to include the REITs diversely owned test would achieve that objective.
Q7: Is there a need for a further test in addition to a GDO? If so, what would thislook like and how would it be policed?
Please refer to our answer to Question 5 above.
Q8: What are the likely impacts of charging gains (and allowing losses) incurred on disposals of residential property by non-residential property companies that are not already operating a trade in the UK?
It is important to ensure that such companies are not disadvantaged when compared to UK resident companies. Indexation allowance should apply and the tax rate set to align with UK corporation tax on gains. In addition, there should be a facility to allow gains in one company to be deemed to arise in other group companies which may have losses, as under section 171A TCGA 1992.
Q9: Are there other approaches that you believe would be more appropriate toensure that non-resident property investment and rental companies are subject to UK tax on the gains that they make on disposals of UK residential property?
No comment.
Q10: Are there any particular circumstances where changing the PRR election rules might lead to unintended consequences?
Our members are predominantly investors in property and therefore we have not provided

comments on the proposed changes to the PRR rules.

Q11: Which approach out of those set out in paragraph 3.5 do you believe is most suitable to ensure that PRR effectively provides tax relief on a person's main residence only?

No comment.

Q12: Are there any other approaches that you would recommend?

No comment.

Q13: Do you believe that solicitors, accountants or others should be responsible for the identification of the seller as non-resident, and the collection of the withholding tax? If not, please set out alternative mechanisms for collection.

Solicitors and accountants may have difficulties in identifying the residence of the seller in a property transaction. Therefore, the need to verify the seller's residence may require changes to the transaction process for all residential sales in the UK - not just those that involve non-residents.

As noted below, we do not think that a withholding tax is the most appropriate mechanism for collecting capital gains tax from non-residents. If a withholding tax is imposed and responsibility for collecting it is assigned to the solicitors in a transaction, it would be possible to avoid the withholdingby using non-UK based solicitors. However, we have no sense of how likely that would be to occur in practice.

Q14: Are there ways that the withholding tax can be introduced so that it fits easily with other property transactions processes?

Designing a collection mechanism which is fair, sustainable and simple is one of the most challenging aspects of these proposals, not least because we know very little about the overseas investors who own residential property in the UK. We consider that a self assessment regime would be preferable to a withholding tax regime because it will allow for a more similar treatment to a UK resident which will therefore be fairer. It will not subject overseas investors to the potential logistical or cash flow difficulties that a withholding tax regime could create.

Notwithstanding the analysis in Annex A to the consultation paper, there is not actually much precedent in Europe for withholding regimes on sales of residential property. We understand that Spain is the only country in Europe to operate a true WHT system on residential property sales. The Spanish system relies on the requirement to use notaries for all property transactions and the notaries have an obligation to withhold and pay 3% of the sales proceeds from a particular transaction to the tax authorities. We do not think that this collection mechanism could be easily implemented in the UK as there is no requirement to use notaries and there is not an equivalent 'gate keeper' on property transactions.

We are supportive of the suggested collection mechanism which has been discussed at various Treasury working group meetings during the consultation period. That is, where a disposal of residential property is made by a person or entity that already has a relationship with HMRC, they would be allowed to self assess their gains made and pay the tax due in line with equivalent UK residents.

Where a person or entity does not already have a relationship with HMRC, they would be required to make a payment on account within 30 days of the transaction, based on an approximate calculation of the gain. They would then be required to submit a final tax return and make any balancing payments within a longer time frame which is comparable to the time given to UK residents. As a last resort, where the seller is unable to calculate the approximate gain within the 30 day timeframe, a withholding tax would be levied.

An alternative approach which could be considered is the regime which is currently operated in Ireland to facilitate the payment of capital gain tax by non-residents. Non-residents that sign up to the regime are provided with a "good compliance certificate" if their tax affairs are in order. Only where a non-resident seller fails to provide a good compliance certificate would a WHT be levied.

Q15: Do you think that the government should offer the option of paying a withholding tax alongside an option to calculate the actual tax due on any gain made from disposal, within the same time scales as SDLT?

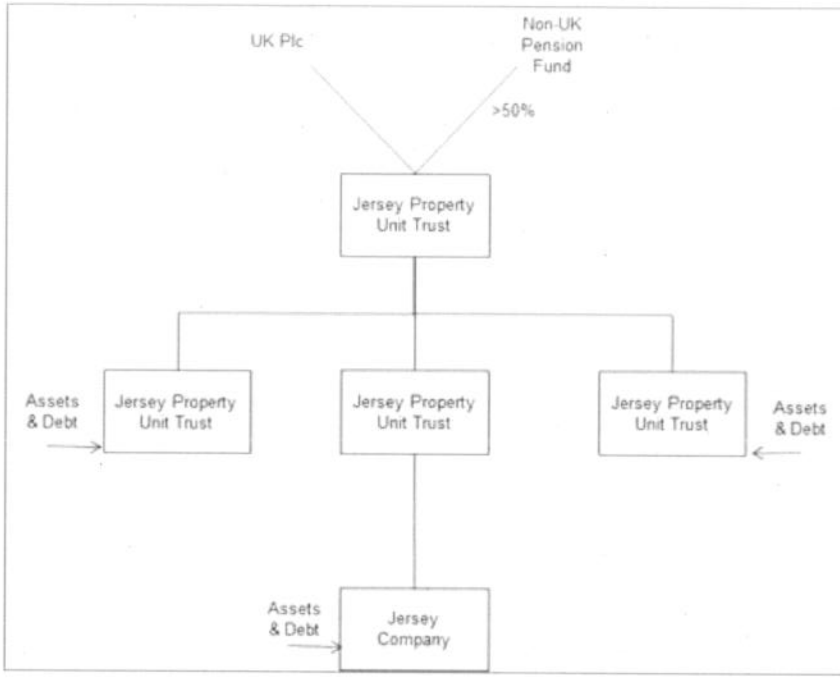
As noted in our response to question 14 above, we do not think that a withholding tax should be the primary collection mechanism for capital gains tax due by non-residents. Instead, a self assessment system should be permitted where the seller already has a relationship with HMRC and if not, a payment on account within 30 days would be required. A withholding tax would only be applied as a last resort where the seller does not have a relationship with HMRC and does not have sufficient information to calculate a payment on account.

Not only would such a system be less disruptive on transactions than a withholding tax, it would also ensure greater parity of treatment between residents and non-residents, as both would report their gains and pay the due tax after the end of the tax year.

A withholding tax could be problematic for other reasons. For instance, where properties are highly leveraged there may be conflicting demands on disposal proceeds as between the lender and HMRC.

Q16: Is it reasonable to ask non-residents to use self assessment or a variant form to submit final computations within 30 days? If not, what processes would be preferable?

We do not think that is reasonable to ask non-residents to submit final CGT calculations within 30 days. Not only would this timeframe put undue pressure on non-residents to calculate their tax liability (potentially without access to all of the information they need to do so), it is also wholly unfair when compared with the time that UK residents are given to calculate their tax liabilities. Just as the rates of capital gains tax should be the same between residents and non-residents, the timing of tax payments should be the same. Therefore, we would be supportive of a system which allows sellers to submit self assessment returns where they already have a relationship with HMRC.


UK Plc
Non-UK Pension Fund
>50%
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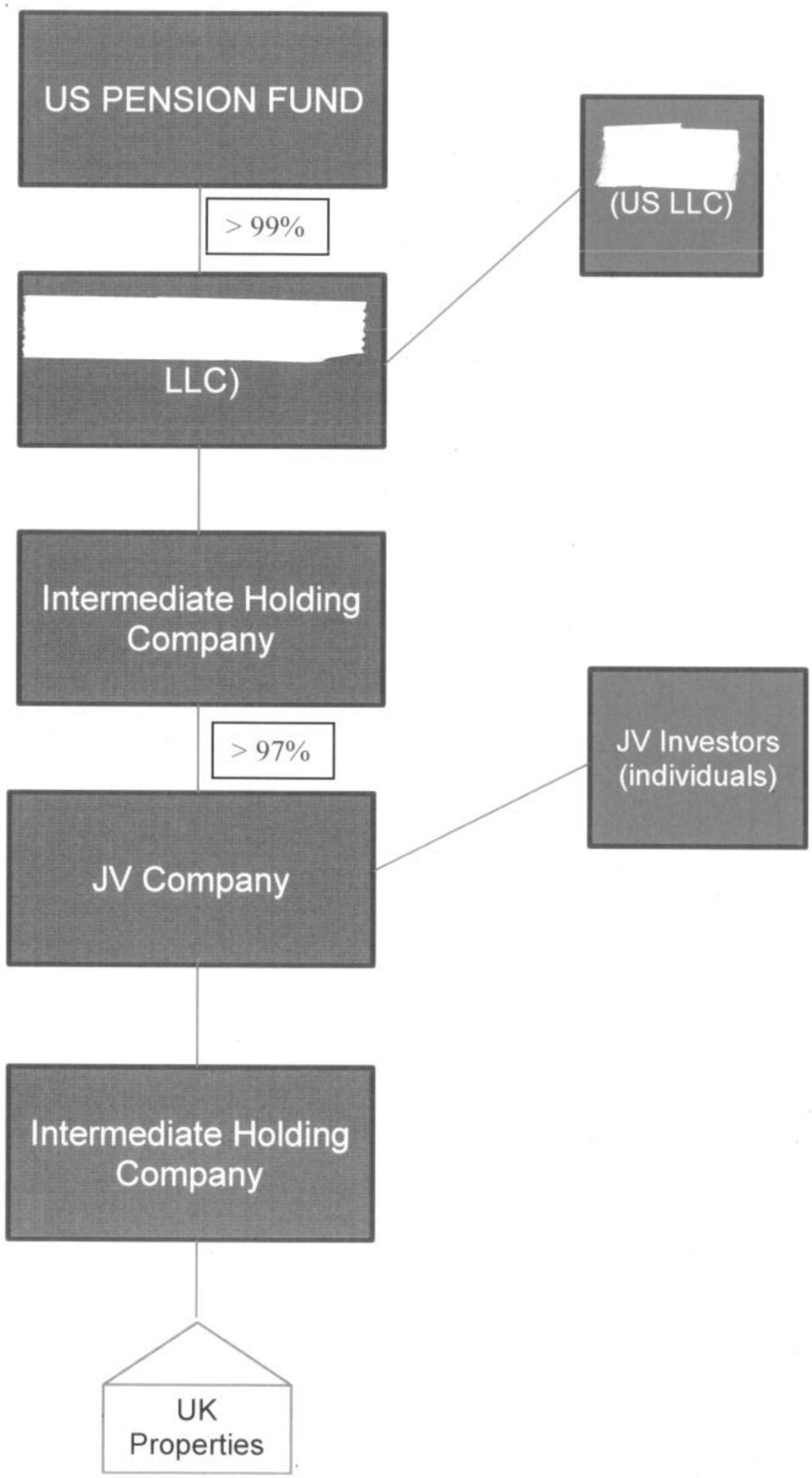
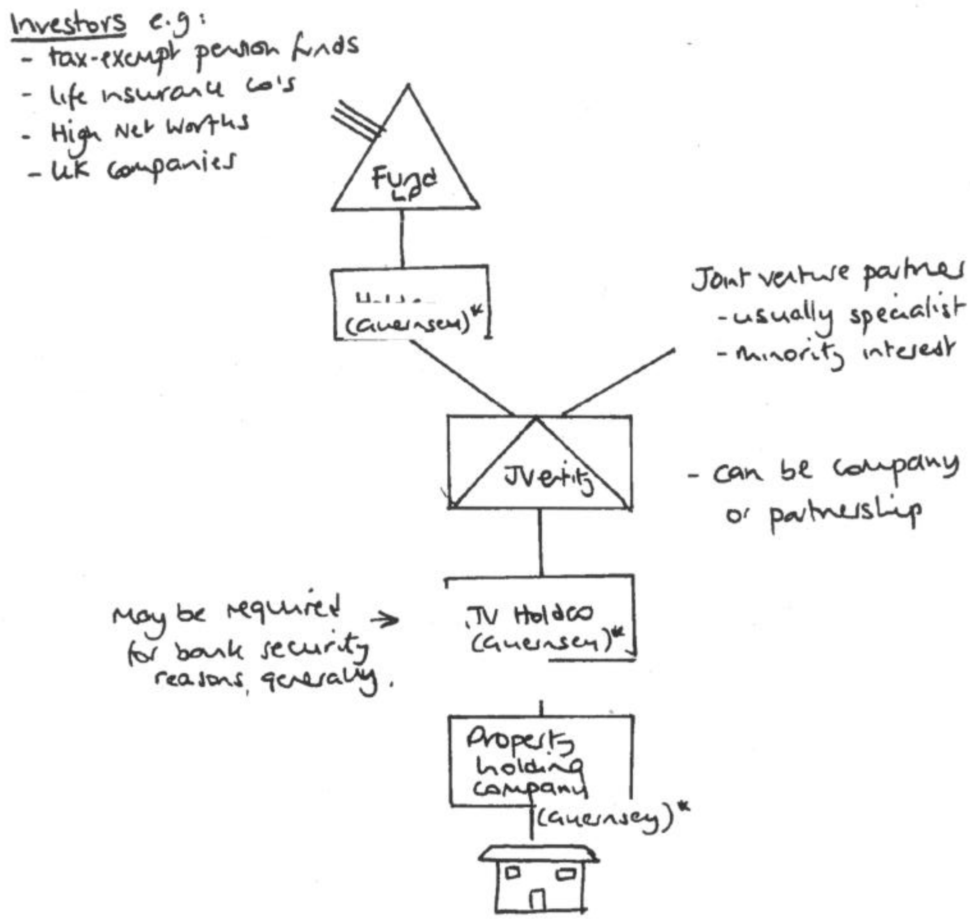
Illustrative Investment Structure



Residential Investment Structure.



* wd be Lux b g / Jersey etc.

EXAMPLE HOLDING STRUCTURE – UK RESIDENTIAL PROPERTY