Grant Thornton

Implementing a capital gains tax charge on non-residents

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to comment on the proposal to introduce a capital gains tax (CGT) charge on the disposal of residential property by non-residents as detailed in the consultation document released by HM Revenue & Customs and HM Treasury on 28 March 2014.

General comments

We consider that in general the UK public are likely to welcome an extension of UK CGT to the disposal of residential property by non-residents. Public opinion and the view of the media has often raised questions over the fairness of the UK tax system and the proposals would suggest that the Government is working hard to ensure that non-residents are taxed in a way that is comparable to UK residents.

We are however, conscious that the mechanics of any new taxes should retain the UK's position as a place 'open for business and investment' and provide certainty to investors. We have detailed the key issues below as well as potential solutions to mitigate any less favourable implications.

Specific comments

1 Impact on the UK residential property market

The demand for residential property in the UK is at an all-time high. As a result demand has far outstripped supply which has led to house prices rising dramatically. For example, the Office of National Statistics found that the average house price in London increased by 11.6% over the year to November 2013 (ONS, House Price Index, November 2013). Furthermore, the CBRE found that last year 18,000 homes were built by all developers across London representing just over a third of the number actually needed.

Investment in the UK new build market, especially that of London, is largely fuelled by foreign and international institutional investors. This type of investor is looking for long-term investments, and is often willing to fund larger scale developments of residential units. Therefore the foreign and institutional investment in new-build property is imperative to ensure the growth of the UK residential property stock as the funding they provide allows developers to take on larger scale developments. Furthermore, a condition of the planning agreements for such developments is that a percentage of the dwellings built must be affordable housing. Large scale developments also provide wider social benefits in the form of employment for local people as well as specific local improvements such as roads, schools or healthcare facilities where such conditions are built into planning agreements.

Recent research undertaken by Knight Frank ('International Residential Investment In London – International Project Marketing 2013) found that overseas investors brought £2.2 billion of cash into the new build London market in 2012. Furthermore, it is clear that overseas investors are also taking on sites that domestic house builders were not interested in.

A number of our clients and contacts have indicated that they are looking to invest into new-built residential projects, including sites in the Midlands and North of England, but are concerned about the uncertainty caused by changes to the UK tax environment that have a direct impact on them.

It is therefore evident that foreign investment is essential to the vitality of the UK residential new-build market and the growth in the supply of such property. As such it is imperative that the development/building of residential property in the UK is encouraged.. It forms a key part of meeting the current housing shortage of over 1 million homes.

We are concerned that the proposed extension of UK CGT to non-residents may have a significant adverse effect on the investment by such investors in the development of residential property in the UK. The proposed changes to the taxation of UK residential property may lead to foreign and institutional investors comparing investment opportunities across Europe. Furthermore, the proposed charge represents the second significant change to the taxation of UK residential property in two years. These successive changes have led to investors asking 'What's next?'. The proposed change is likely to further increase the uncertainty for foreign investors and highlights the lack of stability within the UK tax system.

A decline of foreign investment in UK residential property will undoubtedly reduce the rate at which residential property is developed in the UK, thus further exacerbating the gap between the demand and supply of residential property. The consequence of this will be that residential property prices will continue to rise at an unsustainable rate with most UK purchasers becoming unable to afford to buy their own home. Importantly, we consider that with the continuing shortage of residential housing stock, rents will increase in the short to medium terms as investors seek to pass on any additional burden.

We recognised the importance of existing Government incentives to help young families to enter the housing market, such as the Help To Buy scheme. That said, these incentives support the demand for housing; a change in the tax environment will in our view have a potential negative impact on supply of new housing and so only fuel price growth.

Potential solution

In order to protect the development and vitality of the UK residential property stock, we recommend that the proposal is revised to include a specific exemption for foreign and institutional investors building or developing residential property in the UK.

A further exemption for foreign investors acquiring off-plan units from sizeable residential property developments would also be beneficial. However, such an exemption may result in UK residents being unable to acquire new build residential property where the demand from foreign investors increases. Therefore an alternative may be to review how UK mortgages operate or introduce other incentives for UK purchasers to buy off-plan residential property.

2 Incentive to envelope

The Annual Tax on Enveloped Dwellings (ATED) and ATED-related CGT provisions introduced by the Finance Act 2013 were intended to incentivise investors in high value residential property to de-envelope current structures and discourage the use of such structures to avoid stamp duty land tax going forward.

It is currently unclear as to how the proposed extension of CGT to residential property will interact with these existing provisions. The consultation document suggests that a 'tailored charge' will apply to non-resident companies disposing of residential property which is exempt from the ATED-related CGT owing to an available relief.

The consultation document did not indicate the applicable rate or how it may be calculated. However, in order to prevent the existing ATED and ATED-related CGT provisions from becoming obsolete, it would appear that the rate applicable under the tailored charge would need to be less than 28%.

In contrast, the consultation document explained that the rate of CGT applicable to non-resident individuals disposing of residential property would be either 18% or 28% depending on their other UK income and gains.

The discrepancy between the rates may have the unforeseen implication of once again incentivising the use of enveloped structures when acquiring UK residential property.

For example, where a non-UK resident with significant UK income wishes to acquire a high value residential property as an investment which they will let out, they would be advised to acquire such property through a non-UK resident company. The reason being that as well as the significant inheritance tax protection, the structure will also result in a lower rate of CGT under the tailored charge than if they were to hold the property in their personal name.

Therefore the mechanics of the proposed charge contradict the key incentive of the ATED and ATED-related CGT provisions which was to discourage the enveloping of residential property.

Potential solution

The lack of clarity as regards the interaction between the proposed tailored charge for companies and the existing ATED-related CGT adds to the level of complexity, and clouds the policy rationale, behind the proposals.

It has long been the aim of the Government to simplify UK tax legislation where possible. Therefore, rather than introducing the tailored charge, the Government may wish to consider simply removing the ATED-related CGT threshold, currently £2 million (reducing to £1 million and £500,000 from April 2015 and April 2016 respectively).

This would mean that all foreign companies investing in residential property would be caught by the regime, with the exception of genuine property businesses such as property development or rental businesses. This would achieve the Government's objective of increasing the fairness of the taxation of residential property while not adversely affecting the UK residential property stock.

The removal of the threshold will also affect UK companies that hold residential property. However, such ownership is unlikely to be established by a UK resident individual unless the property was being developed or let out commercially in which case it would be exempt from the ATED-related CGT.

3 Practical issues of proposal

The proposed CGT charge is to apply only to those individuals or entities that are non-resident. However it will in practice affect all UK residential property transactions as it will need to be established whether or not the seller is non-resident. Establishing the residence status of the seller is likely to be time consuming and put a significant strain on the already stretched resources of HMRC. It is also likely to delay property sales and increase costs where professional intermediaries are required to clarify the status of the vendor in order to apply the proposed withholding tax.

Potential solution

Currently, where a non-resident is renting out property they are required to complete a UK tax return in order to avoid or claim back income tax withheld on the payment of rent. In such circumstances the submission of these returns will provide the required information as to the residency of the individual or entity involved.

However, what if the property is not being let out? The individual or entity may still register under the non-resident landlord (NRL) scheme at which point the necessary information would be obtained, however they are not required to do so. It would therefore be beneficial if non-residents who were not planning to let out their residential property were incentivised to register under the scheme.

This could be achieved by linking the registration to the application of the proposed CGT 'withholding mechanism'. For example, it could be that where a non-resident registers under the scheme they are entitled to receive the gross proceeds of the sale as opposed to an amount being withheld by a solicitor/notary. They would subsequently calculate the correct tax payable and submit a return under the

4 Impact on UK residents

The consultation document explained that in order for the new capital gains tax charge on non-residents to be fair and sustainable, the rules regarding Private Residence Relief (PRR) relief will need to be altered such that the relief is available to non-residents in some circumstances.

However, the consultation document detailed the Government's concern that once the relief is made available, non-UK residents may simply elect for their UK property to be treated as their main residence in order to avoid being subject to CGT. It was therefore proposed that the ability of an individual to elect which property is to be treated as their main residence for these purposes is removed. Instead it has been proposed that an individual's main residence will now be determined either by evaluating the facts of the case or by the period of time spent by that individual in the property in question.

By removing the ability of an individual to elect which of their properties is to be treated as their main residence, a significant number of UK resident individuals with multiple UK properties will be worse off. We are concerned that such repercussions have not been considered for all stakeholders.

For example, a typical scenario is where an individual owns a property in London which they occupy five days a week when working in the City and a property in the countryside which they occupy during the weekends. The countryside property is always occupied by their family, their post is sent there and they are registered as living at that property on the electoral role.

Under the proposed facts based rule, the countryside property would be treated as being their main residence. However, the individual is likely to want to elect the London property as their main residence given that it is more likely that it will be that property that is sold when they retire and move permanently to the country. That individual would therefore be significantly worse off as a result of not being able to elect which property is to be treated as their main residence.

Another example would be a UK citizen who has chosen to retire overseas over the last few years. They retained their UK property as it has often been difficult to sell it without making a substantial loss. Whilst the property was their main residence, it remained exempt from UK CGT. As they became non-UK resident, the property was exempt from CGT also. The change would mean that these pensioners will now be subject to CGT on their UK property, substantially reducing their net wealth.

A further scenario may be where a non-resident individual has a house in London, Paris, Milan, New York and Los Angeles which are all available for their occupation. In a certain tax year they spend 70 days in the UK. How will HMRC determine whether the London property and not one of the overseas properties is their main residence? It would appear that enforcement under the proposed changes may be difficult and time consuming.

The Government may also need to consider the scenario where a non-resident individual only owns one property, being in London, but rents properties in other countries where they spend a lot of time. In such circumstances, would one of the rented properties be considered as being their main residence under any revised rules? A similar scenario may be where the individual does not rent other properties but simply occupies them as a guest. Again, would such properties be considered as being their main residence for PRR purposes.

It is clear that if the rules governing which property is to be treated as an individual's main residence are to be changed, the legislation will need to be sufficiently complex so as to address a wide range of different scenarios such as those detailed above. If this is not the case, taxpayers will be left with a significant degree of uncertainty which is not acceptable.

As a result we consider that the negative implications for UK residents of the proposed changes are likely to outweigh the loss of revenue expected by the Treasury where the ability to elect a main residence remains in force.

Does the main residence election need to be removed?

The Government has proposed removing the ability of an individual to elect a property as being their main residence in order to prevent non-residents simply electing their UK property as their main residence in order to avoid CGT.

In light of the potentially significant implications of the proposed change for UK resident individuals, as detailed above, it should be considered whether the Government's concern is justified.

In our experience, the majority of non-residents owning residential property in the UK do so as an investment and therefore let the property out commercially, as opposed to keeping it available for occupation by them or their family. This became even more evident with the introduction of the ATED and ATED-related CGT provisions which meant that previously vacant properties held via non-UK companies also began to be let out.

Therefore on the basis that the majority of non-residents let out their property and do not occupy it, it is unlikely that the property would have qualified for PRR based on the current legislation. Therefore it does not appear that the Treasury would lose out to a great extent by extending PRR relief to non-residents without restricting their ability to elect their main residence.

Potential solution

The concerns of the Government may be mitigated further by considering how PRR relief may interact with an individual's residency status where a non-resident individual has elected for their UK property to be their main residence.

The tax implications of an individual becoming resident in the UK for income and capital gains tax purposes is significant.

Therefore there is potential for the statutory residence test to be changed such that where a non-resident individual elects for a UK property to be treated as their main residence, it increases the likelihood of them being treated as being UK resident for tax purposes.

The current statutory residence test includes a sufficient ties test which essentially determines the number of days an individual may stay in the UK before they are deemed to be UK resident based on their various ties with the country. The fact that an individual elects that their UK property is their 'main' residence, should be treated as a significant tie to the country. Therefore such an election should be given additional weight compared to where an individual simply has a property in the UK available for their occupation. This additional weighting would mean that by making the election the individual is increasing their risk of becoming UK resident, which can have significant tax implications. Thus it would be expected that in a lot of cases the individual may be deterred from making the election given that it may affect their tax residence status year on year.

With regard to the operation of the sufficient ties test, the election of a main residence in the UK could:

- be treated as being equivalent to two UK ties e.g. an individual meets the accommodation tie, however as they have elected for it to be treated it has their main residence they are treated as having two ties;
- be added as a new standalone tie;
- have the effect of reducing the '90-day tie' – e.g. making it the '60-day tie'.

Responses to consultation questions

Question 1: Would an exclusion of communal property from the scope of the new regime result in any unintended consequences?

The consultation document explains that the government wants to ensure that residential property that is primarily for communal use is not affected by the extension to CGT. However, the exact method of this will be achieved has not been made clear. For example, will a definition of 'communal property' be drafted which will apply solely for the purposes of the new CGT charge? Property then falling within that

accompanied by specific exclusions with the aim of exempting certain communal properties?

As is always the case with definitions such as these, there is clearly going to be ambiguity with regard to certain situations. We therefore believe it would be very useful if HMRC provides a specific definition of communal property.

Question 2: Are there any other types of communal residential property that should be excluded from scope?

The consultation document suggests that the government wishes to introduce a general charge with limited exemptions. This is understandable as the introduction of specific exemptions can add significant complexity to the regime where a number of different definitions need to be introduced.

However, there are a few social and economic situations that would warrant such added complexity so as to prevent them falling within the charge.

Such potential exclusions may include:

- student accommodation (but not including private lets)
- assisted living accommodation for elderly individuals. This covers a range of different types of accommodation from warden-controlled to fully-assisted

Question 3: Are there any particular circumstances where including non-resident partners in scope of the charge might lead to unintended consequences?

The key point to consider with regard to non-resident partners is whether the proposed charge will indeed affect the partners or whether it will affect the partnership itself. This is dependent on whether HMRC view the non-UK partnership as being opaque or transparent for tax purposes.

HMRC have issued a list of various non-UK entities where it has opined on whether they are to be treated as opaque or transparent for UK tax purposes. However the list is not exhaustive and therefore it is likely that a number of non-UK partners who haven't previously considered their position with regard to this point, may need to do so under the new CGT charge. This may result in a number of partners using the non-statutory clearance procedures to seek clarity on the point.

Question 4: Are there any particular circumstances where including non-resident trustees in scope of the charge might lead to unintended consequences?

Unfortunately, at the moment the proposals are not sufficiently defined to be able to answer this questions with any precision.

Question 5: 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?

The feedback we have received from various working groups is that a GDO would work well for open ended investment funds as it is unlikely that investors are likely to use such funds avoid the proposed charge due to the significant complexity that it would involve.

However, it was felt that the GDO would not be the best option for closed ended investment funds. It has been suggested that the existing close company rules governed by CTA 2010, s 439, subject to any necessary adjustments, may be appropriate for such funds. These rules would apply upon the sale of the investors' interests in the fund and therefore although the fund may be initially quite closely held, as it grows over time this may no longer be the case at the date of disposal.

Question 6: Are there any practical difficulties in implementing a GDO test?

There is insufficient detail to answer this, but the key will be to ensure that the test is flexible so it can be applied at the right level in the structure.

Question 7: Is there a need for a further test in addition to a GDO? If so, what would this look like and how would it be policed?

As mentioned above, it may be worth considering whether the close company rules, governed by CTA 2010, s 439, should be applied to closed ended investment funds as opposed to the GDO. It would seem that this would be a better fit, however the introduction of an additional test would clearly add complexity.

Therefore it may be that the GDO is structured so that it is flexible or can be modified so that the funds that the Government wishes to fall out of the charge are excluded.

Question 8: 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 isn't clear at this stage how the proposed regime would operate. Once clearer guidelines are issued, it will be easier to answer this question.

For example, it is unclear as to whether the charge will apply only to those non-UK resident companies that would be treated as close companies were they UK resident.

Subject to this, it will need to be considered what reliefs will be available to the non-UK residents subject to the charge, such as indexation, tax neutral transfers between group companies etc.

Question 9: Are there other approaches that you believe would be more appropriate to ensure 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?

Unfortunately it is not possible to answer this at the current time.

Question 10: Are there any particular circumstances where changing the PPR election rules might lead to unintended consequences?

We understand the Government's concern that the operation of the TCGA 1992, s 222(5) main residence election may allow non-residents to avoid the new CGT charge.

The difficulty is, as discussed during recent working groups, the ability to make elections is of great practical value for residents with second homes and will result in unfairness to UK residents.

Furthermore, in our experience, the majority of non-residents owning residential property in the UK do so as an investment and therefore let the property out commercially, as opposed to keeping it available for occupation by them or their family. This became even more evident with the introduction of the ATED and ATED-related CGT provisions which meant that previously vacant properties held via non-UK companies also began to be let out.

Therefore on the basis that the majority of non-residents let out their property and do not occupy it, it is unlikely that the property would have qualified for PRR based on the current legislation. Therefore it does not appear that the Treasury would lose out to a great extent by extending PRR relief to non-residents without restricting their ability to elect their main residence.

Question 11: 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?

reason being that neither of them solve the problem where spouse/civil partners, on the balance of facts, have a different main residence. We are therefore of the opinion that it is very important that the ability for an individual to make a main residence election remains available.

Question 12: Are there any other approaches that you would recommend?

It is important to retain the ability to make a main residence election. However, to alleviate the Government's concerns it may be that a change is indeed required in order to avoid the new tax charge being undermined.

Two potential approaches may be:

- introduce certain restrictions so that the election may only have a limited use for non-residents
- the statutory residence test could be amended so as to disincentivise a non-resident from making the election due to potential implications on their residence status.

Question 13: 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.

In reality is may not be possible to establish whether or not a person is non-resident part way for a year. The reason being that residence follows the tax year and therefore a person's position may change depending on their actions in the latter part of the year.

Where a non-UK resident is already within the non-resident landlord scheme it would sensible for any tax due on the disposal of UK property to collected via that mechanism.

Where the non-resident is in good standing with HMRC they can apply to receive rents gross, without the deduction of tax. This could similarly be applied were any withholding tax or payment on account mechanism to be introduced. The non-resident could then simply calculate the tax due as part of the their annual return and pay the tax over to HMRC on the normal due date.

Where there are professional advisers involved with property transactions it has been suggested that they are made responsible for withholding any tax due under the new CGT charge.

However, this may not work in practice as it is perfectly conceivable that a UK situated property may be sold without a UK professional advisor being employed by either party.

The calculation of a payment on account may also not be possible as detailed in our response to Question 15 below.

Therefore it may be that a normal CGT computation is used either through the non-resident landlord scheme or self-assessment system.

Question 14: Are there ways that the withholding tax can be introduced so that it fits easily with other property transactions processes?

We do not believe that the withholding tax will readily fit with other property transaction processes and it is likely to pose a number of implementation issues.

The reason why such a mechanism is able to operate in other countries is because it is mandatory in those jurisdictions for a notary to be used when selling a property who are then responsible for withholding the tax. This is however not the case in the UK,. As mentioned above, it is possible in the UK for property to change hands without a UK professional adviser being employed.

Question 15: 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?

We understand that where an individual is not within the UK self-assessment regime they have the option to either make a payment on account within 30 days of conveyance or within 30 days of conveyance submit a CGT computation and pay associated tax over to HMRC.

It is not clear how the individual would go about calculating the payment on account. Therefore we are inclined to favour the computation method as a method of estimating the tax due.

Question 16: 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?

It may be that there are some EU points that need to be considered where there is a requirement that non-UK residents not covered by self-assessment make a tax payment within 30 days. It may indeed be that the 30 day requirement is not actually required where the individuals is resident in a jurisdiction that has a double tax treaty with the UK.

Contacts

For any queries in respect of our comments in this document, please contact:

Grant Thornton UK LLP
Grant Thornton House
Melton Street
Euston Square
LONDON
NW1 2EP