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By Email

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Dear Sir

Implementing a capital gains tax charge on non-residents

We refer to the consultation document published on 28 March 2014 entitled "Implementing a capital gains tax charge on non-residents." In this response we will be focusing on question 8. In relation to the other questions we are in agreement with the British Property Federation response.

Our perspective is that of lawyers who advise on commercial property transactions, including commercial residential transactions. In summary, our concern is that consequential changes needed to introduce this charge are far greater than the consultation document anticipates, especially if HMRC wishes to avoid challenge to the new rules in the CJEU. This is because of mismatches between the corporation tax on chargeable gains and the CGT regimes.

In particular, we are not convinced that introducing a tailored rate of CGT for non-resident companies will avoid the need to substantially revisit the rules governing tax deductibility of debt related costs for non-resident companies and to significantly amend the CGT group relief rules.

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?

There is likely to be an impact on the mechanisms used for funding commercial residential property investments by non-resident companies, including student accommodation.

This is because the differences between the UK corporation tax and CGT rules mean that non UK resident companies will arguably be discriminated against under the new regime by being unable to use carried forward non trading debits against any chargeable gain and being unable to set off premiums paid on the discharge of a debt secured on the property against the chargeable gain.

These concerns are best demonstrated by discussing third party mezzanine finance which is often used in real estate transactions. There are several variants which can be used here. Often interest on the mezzanine finance will be rolled up while surplus income over the interest on the bank debt is used to pay down the principal of the bank debt. This may be combined with a redemption premium so that, in addition to the interest paid on the mezzanine loan, at a time of repayment the debtor pays to the lender an amount determined by reference to the price at which the property was sold or the value which was attributed to the property when determining the price paid for the shares in the property owning company. Alternatively there may be a fixed amount of interest which must be paid in any event and additional interest the exact amount of which will be determined by reference to the price at which the property was sold or the value which was attributed to the property when determining the price paid for the shares in the property owning company. Often this additional interest will be capped. A commercial justification for such a premium or additional interest is that it reflects the commercial risk that a mezzanine lender may not receive repayment of the principal amount lent. These sums can be fairly substantial.

Treatment of UK resident companies

The payment of a premium or additional interest will not be a cost of disposal for the purposes of corporation tax on chargeable gains. This is because under section 38 TCGA it is not a cost incurred on the acquisition or enhancement of an asset and it is not an incidental cost of disposal. However, it should, at least if paid to a UK corporation tax payer be a non trading debit and thus capable of being offset against chargeable gains to the extent that it is not treated as a distribution. This is because it should be treated either as an expense incurred directly in bringing a loan relationship into existence (see section 307(4) CTA 2009) under the loan relationship rules (e.g. arrangement fees) or as a payment under the loan relationship (e.g. payment of premium on repayment linked to value of property), assuming that the premium/additional interest is not in excess of a reasonable commercial return and disallowed as a distribution. Care does need to be taken in structuring the terms of such loans in order to ensure that a deduction is available, but in practice this is achievable.

In the case of a UK resident property company, any excess of non-trading debits over non trading credits can be set against total profits (which includes capital gains - see sections 4 and 1119 CTA 2010) of the company for the period in which the loss is made (see section 459 - 461 CTA 2009) and if not otherwise used can be carried forward and set against non-trading profits of the succeeding accounting period (see section 457 and 458 CTA 2009). Non trading profits means so much of a company's profits as do not consist of trading income (see section 457(5) CTA 2009) so includes capital gains. Therefore any otherwise unused deductions for interest and a premium are capable of being offset against the chargeable gain.

Current treatment of non-resident companies

For a non-resident company section 58 ITTOIA provides that any costs of repaying a loan which are attributable to being repaid at a premium are not deductible for income tax payers. Therefore a premium payable on redemption would prima facie not be deductible. Even if it were, there is no provision which would allow a non-resident property investment company to set any unused interest deduction against any chargeable gain.

Currently as a non-resident company holding real estate as an investment is not subject to UK tax on chargeable gains and often the interest payable on bank and mezzanine debt shelters most of the income derived from the real estate, it normally does not matter that no deduction is available for the premium.

Impact of proposed change in rules

The current proposed changes would result in the non-resident company's gain being calculated ignoring any premium paid on redemption of the loans and without any ability to set off any unused interest deductions.

Therefore on an ongoing basis non-resident companies will be disadvantaged because UK resident companies will be able to obtain an effective tax deduction for a greater proportion of their borrowing costs than non-resident companies. It is far from clear to us that being taxed at a lower rate of tax will compensate for the risk of being taxed on a gain in excess of the economic profit (if any) made. It certainly seems odd that the choice of using a UK resident or a non UK resident company may depend on whether or not mezzanine finance needs to be obtained to fund the acquisition and whether the anticipated profits mean that the lower rate of tax compensates for not obtaining a tax deduction.

It should also be borne in mind the new rules will potentially impact on existing commercial funding structures which were put in place at a time when no UK CGT charge was envisaged. At that time there would have been no need to ensure that a payment was an incidental cost of disposal within the meaning of section 38 TCGA 1992 or that any form of tax deduction be obtained for the payment. While this may not be a significant issue if a disposal takes place shortly after April 2015 because the proportion of the gain subject to tax should be comparatively small, this will become increasingly important especially if the business plan envisages or market conditions mean that a disposal will not take place for a few years.

In considering the implications for property companies of the changes to the rules we have become conscious that there are situations where we can envisage that the best advice we could give to clients is that with effect from April 2015 they should consider making a company UK resident if they wish to avoid a mismatch between commercial and taxable profits. This raises the question of whether the combination of the new CGT rules and the current debt rules is EU compliant.

Often with UK rules that are of doubtful compliance with EU principles, taxpayers and their advisers will structure transactions so as not to risk the costs and delay of litigating the point.

However, the position is likely to be different here. First, it is possible that there will be some post 2015 disposals in relation to properties acquired pre 2015 where enough additional tax will be in question to make litigation worthwhile. In particular, where mezzanine loans were taken out during 2013 and a business plan assumes a disposal between 2018-20 a significant part of the gain will be taxed under the new rules and the absence of an effective deduction for any redemption premium/additional interest will be important. For example, if a £200m property is acquired and £40m of the cost is financed with mezzanine debt which envisages that on exit up to an addition 10% per annum interest will be payable then after 5 years of compounding there will be up to around £12.2m of payments due which will reduce the economic profit but not the taxable profit.

Second, existing non-resident mezzanine lenders may find that their business model is sufficiently compromised to justify challenging the position or supporting a borrower's challenge of the position.

There is therefore a real risk that taxpayers will have a financial incentive to challenge the existing UK rules as being discriminatory or breaching the freedom of establishment rules.

An additional risk for HMRC of not addressing this issue now is that the provisions of CTA 2010 which disallow a deduction for distributions only apply to corporation tax paying companies so if it was held that disallowing an effective deduction for a premium paid on redemption was against EU law, HMRC may not be able to rely on CTA 2010 to disallow a deduction because it exceeded a reasonable commercial return.

Group relief rules

As the proposed rules apply to commercial residential property arrangements, it is more likely that there will be or have been intra-group transfers of property investments. It would be helpful if the treatment of such transfers could be confirmed as part of the next stage of the consultation process.

Section 171 TCGA means that intra-group transfers of chargeable assets are at no gain no loss. For these purposes group members must either e UK resident or within the charge to corporation tax on chargeable gains if non- resident. Currently as there is no need for the point to be governed the relief does not apply to transfers to and from companies which are not subject to corporation tax on chargeable gains.

We are assuming that it is not currently proposed that transfers of real estate between non–UK resident companies which are not subject to corporation tax and UK resident companies of real estate will fall within section 171 because the differential tax rate would unduly favour transfers to non-residents. While it is less clear that there would be a policy reason for preventing transfers to UK resident companies from non-resident group companies, it would we suspect be problematic to have such a clearly discriminatory provision. Even in light of the fact that the relief would also not apply on transfers from UK corporation tax paying companies to non-residents, we trust that HMRC are convinced that restricting group relief to corporation taxpayers can be justified under EU law.

In the case of non-resident groups we believe that an equivalent of section 171 TCGA should be available for intra group transfers between non-resident companies as there seems to be no good reason for intra group transfers within non-resident groups to be treated less favourably than transfers between UK resident groups. Section 14 TCGA perhaps offers a relatively painless template for legislation and demonstrates that there is an existing policy of not imposing tax in respect of transfers between non-resident group members.

We note that section 171 (2) (ba) contains a provisions disapplying ATED related-gains and losses from the group relief regime. We assume that this was for a specific reason linked to the ATED regime and would not be repeated for these purposes.

Loss surrenders

Section 171A TCGA allows losses/gains to be reallocated within a UK CGT group. It requires the gain or loss to be subject to corporation tax in order for the legislation to apply and so prima facie would not apply to allow reallocation of losses/gains on disposals of chargeable assets between non corporation tax paying group members or between corporation tax and non-corporation taxpayers.

We believe that it would be appropriate to extend section 171A to specifically apply to allow members of non-resident groups to reallocate gains/losses on chargeable assets between themselves.

Section 13 TCGA 1992

Currently there is no general exemption that if UK tax is paid then no charge to tax will arise under section 13 TCGA on UK resident shareholders in a non-resident company. There are specific exemptions in section 13 for gains chargeable under sections 10B (non- resident companies with a UK PE) and section 13 (1A) (ATED gains) and while it is not mentioned in the consultation, we would assume that one will be introduced. If there is a tailored rate of tax there may still be some differential tax advantage in using a non-resident company, but we cannot see that this justifies a higher overall charge of tax to be suffered.

Time Apportionment

We note that the current consultation does not discuss the basis on which gains will be apportioned where a property was held prior to April 2015. We are assuming that the ATED model of rebasing to market value as at April 2015 with an option to elect for time apportionment will be chosen, but it would be useful if this could be confirmed.

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.

We are not convinced that a withholding obligation is necessary or appropriate. Even if it is considered necessary, it seems inappropriate to link it to the SDLT return as that is the responsibility of the buyer's solicitor who has no contractual relationship with the tax payer.

In relation to commercial investment in residential real estate there may be unfortunate commercial implications because the withholding obligation might mean that it was not possible for a borrower to comply with its obligations to bank lenders. Thus if there was, for example, a 10% withholding obligation and the seller was required to pay the entire amount of the sale proceeds to the bank then it would have to find an extra 10% of the price to pay the bank before the bank would release the charge and allow completion to take place.

Commercially a clash between a withholding obligation and the banking documentation could arise if the property had declined in value since acquisition (but by law an initial withholding was still required) or because the property being disposed of represented a part of a larger portfolio on which the lending was secured. At the very least there would be a cash flow cost in a borrower obtaining funding to meet the difference and it is possible that this might result in certain deals being unable to go ahead. It may also mean that on an ongoing basis it is less attractive for banks to lend to non-resident companies than to UK resident companies.

While for post 2015 loans no doubt banking documentation and practice will change to meet the issues, the proposals will impact on loans made before any withholding obligation had been proposed.

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?

It is far from clear to us that the option will be taken up other than in exceptional cases

If the collection mechanism is linked to the SDLT return, this requires a buyer's solicitor not only to establish whether or not a seller is non-resident but also to work out the seller's tax liability. It seems unlikely to us that any solicitor acting for a buyer of residential property would be willing to do so or to rely on a representation by the seller as to the amount of tax payable. We assume that if a solicitor under-deducts then HMRC would look to the solicitor to account for the tax and even if there was a reasonable mistake defence, it would clearly be safer for the solicitor to withhold at the flat rate.

If you have any questions or wish to discuss any of the points raised in this submission, please contact either

Yours faithfully

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