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Briefing note 31 March 2014

Implementing the CGT charge on non-residents disposing of UK residential property post-April 2015 - A Bombshell

These proposals are likely to add cost and complexity for residential real estate transactions as businesses try to get to grips with one of the most dramatic changes in the taxation of UK real estate since the introduction of CGT in 1965.

The Government has published its initial proposals for the introduction of capital gains tax (CGT) on gains made by non-residents disposing of UK residential property from April 2015.

Hopes that the charge would be narrowly focussed on non-resident owner-occupiers of UK homes have been dashed. The Government is embarking on a consultation process this year to confirm the scope and structure of the new regime, but its initial proposals indicate that the CGT charge will apply to a far wider field including businesses that hold residential property for rental (including developers who build-to-let) and there will be a new withholding tax at the point of a property transaction to collect it. Coupled with the recent package of measures imposing CGT on corporate 'envelopes' of residential property over £500k (together with the 15% SDLT charge and Annual Tax on Enveloped Dwellings) which will continue to run in parallel, the UK tax rules applying to residential property are likely to become incredibly complex and contain traps for the unwary.

The consultation document is available to read here: https://www.gov.uk/government/consultations/implementing-a-capital-gains-tax-charge-on-non-residents

Background:

To put this in context, the Government are coming from the following direction:

"The government does not believe that it is right that UK residents pay capital gains tax when they sell a home that is not their primary residence, while non-residents do not."

"We do not believe that it is right that UK companies are subject to tax on gains that they make from disposals of residential property, whereas non-residents are not."

"This measure will bring the UK into line with many other countries that already charge capital gains tax on the basis of the location of the residential property rather than the location of the seller."

The Government says the overarching objectives for the changes will be guided by fairness, sustainability and simplicity.

The practical reality is likely to be added cost and complexity for residential real estate transactions as businesses try to get to grips with one of the most dramatic changes in the taxation of UK real estate since the introduction of CGT in 1965.

Key Points:

- The new CGT charge will apply to non-resident owners of UK residential property holding the property as an investment, for a letting business or home. It does not appear it will apply to non-resident owners of UK residential property who acquire or develop the property for sale – i.e. 'traders' in UK real estate: they are already subject to UK corporation tax or income tax depending on the precise facts and subject to the application of any relevant double tax treaty.
- The new CGT charge will only apply to 'residential' property and not 'commercial' property (such as offices, shopping centres or industrial buildings). The precise definition of what is or is not 'residential' property will thus be very important.
- There will be no grandfathering for existing owners of residential property who come within the scope of the charge other than CGT will only apply to gains arising after the charge comes in (April 2015).

- **Definition of 'Residential Property'**
  - The CGT charge will be focused on property used or suitable for use as a dwelling i.e. a place that currently is, or has the potential to be, used as a residence.
  - This will include property that is in the process of being constructed or adapted for such use.
  - Residential property that is primarily for communal use, such as boarding schools, nursing homes, army barracks and prisons, are to be excluded from charge.
  - The Government does not propose that residential accommodation for students should be excluded except as part of a hall of residence attached to an institution.
- There will be no exemption for disposals of multiple dwellings (six or more separate dwellings) of the kind currently available under SDLT (which treats such multiple disposals as 'commercial').
- **Indirect Residential Property Ownership**
  - The Government is considering charging gains made on disposals of UK residential property through different forms of non-resident entity.
  - The Government proposes that trustees that are not regarded as UK resident should be subject to CGT on disposals of UK residential property, and so proposes to include all types of non-resident trust within scope of the CGT charge, in the same way that all trusts with UK trustees are subject to UK CGT.
  - Disposals made via tax-transparent partnerships will likely be taxed according to the existing rules on apportioning partnership chargeable gains to the partners, so that non-resident persons who are partners will be charged to CGT to the extent that gains are attributable to them but subject to any applicable exemption they themselves might have.
  - The Government does not generally propose to tax non-residents on disposals of shares or units in a fund (examples given are collective investment schemes (CISs) and Property Authorised Investment Funds (PAIFs)). However, to prevent use of funds for avoidance purposes, the Government suggests that in some cases a charge at fund level could be levied, and intends to introduce a genuine diversity of ownership (GDO) test so that closely held funds are subject to the charge. The GDO test is to be based on the existing approach in the UK authorised funds legislation and offshore funds rules. This is likely to mean that residential property held by a Jersey Property Unit Trust with a small number of unitholders would come within the charge.
  - Pension funds will, however, be excluded from the CGT charge.
  - Non-residents investing in UK residential property through UK REITs will not be subject to the CGT charge, and neither will foreign REITs holding residential property where they are 'equivalent to' UK REITs. HMRC are currently drafting guidance on what constitutes a 'foreign REIT equivalent'.
  - The CGT charge is likely to apply to all UK residential property sold by non-resident corporates, even where the value is below the £500,000 ATED/15% SDLT threshold. The ATED-related CGT charge applicable to corporates holding residential property over £2m (reducing to £500k from April 2016) - @28% - will continue to run in parallel and apply first, defaulting into the wider CGT charge where the ATED-related CGT charge does not apply (this could easily happen as the ATED-related CGT charge does not apply to businesses and is focussed on owner-occupiers). The applicable CGT rate will be confirmed by the Government at a later date. The Government is considering a tailored approach within CGT or corporation tax to charge gains made on disposals of UK residential property by non-resident companies. This approach would charge only gains made on disposals of UK residential property by non-resident companies and allow losses that non-resident companies incur on disposals of UK properties.
- **Non-resident Individuals**
  - The Government would likely make private residence relief (PRR) available to non-resident individuals subject to the CGT charge in certain circumstances (e.g. where a person with a UK private residence emigrates). The Government is also considering wider changes to the PRR rules (note, the changes would affect others and not just non-residents):
    1. Taxpayers would need to demonstrate their entitlement to PRR – Record keeping needed;

2. Government may remove ability to elect which residence to have as the main residence and replace with an evidence based test;
3. Replace the ability to elect with a fixed rule (e.g. based on time spent at residence).

- The Government does not intend to alter other reliefs relating to a person's main property (e.g. absence reliefs).
- The annual exempt amount (currently £10,900) is likely to be available to non-resident individuals subject to the new CGT charge, who will also likely be allowed to offset losses on UK residential property where appropriate.
- The Tax rate charged on non-resident individuals is likely to mirror higher (28%) and lower (18%) rates for UK residents as appropriate. As mentioned above, the Government is considering the rate that should apply to gains made by other non-resident entities (e.g. funds which fail the GDO test and corporates) and will announce it at a later date.

- **Implementation**
  - One of the main challenges implementing CGT on non-residents is how to collect the tax. The Government proposes to introduce a withholding tax mechanism based on the value of the property at the point of disposal, operating alongside a self-reporting option, to collect the new CGT charge.
  - The Government is drawing inspiration from Spain, Australia and Canada which operate withholding taxes to ensure collection of CGT from non-residents. There is a suggestion that solicitors, accountants or others involved in the conveyancing process might have to be involved in the collection system with the CGT withholding tax being paid within 30 days of the transaction. This will be developed further during the consultation process.

Next Steps

Responses to the Consultation Documents are requested by 20 June 2014 following which there is likely to be a period of discussion with HMRC/the Treasury during which these proposals will be refined and finalised. Officials will be holding working groups over the consultation period to discuss further and we intend to participate in this process.

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