Summary of draft rules for collective investment vehicles (CIVs)

- In addition to the new rules bringing non-resident persons into charge to UK tax on gains on direct and indirect disposals of UK property, a special regime for CIVs has been announced.
- The definition of a CIV is broad and will cover most real estate fund and joint venture structures including partnerships, unit trusts and real estate investment trusts.
- Gains on the disposal of interests in a CIV, or by a CIV which is UK property rich and on certain other assets with ‘an appropriate connection to a CIV, will be subject to UK tax, unless the person making the disposal benefits from a specific tax exemption.
- Offshore CIVs in non-corporate form will be treated as companies unless they are partnerships. Some will be able to elect for tax transparency such that their gains will be chargeable on investors, whilst others may be able to make an exemption election giving entity level tax exemption for gains and deferring any tax charge until investors realise their investment or receive distributions out of gains. The exemption election will not be available to closely-held funds (with an exception where those funds are close only due to the participation of qualifying institutional investors) and will come with reporting obligations and conditions which may prove onerous to manage.
Non-resident chargeable gains - CIVs

On 7 November 2018, the UK Government released with Finance (No. 3) Bill, draft legislation on a new capital gains regime for CIVs. The draft rules are likely to have a significant impact for many funds and joint ventures investing in UK real estate. This alert is based on this draft legislation.

Given the volume of investment in UK commercial property through offshore CIVs, including by investors who are tax exempt other than by reason of residence, it is welcomed that the UK Government recognised specific adaptations of the new rules taxing non-residents’ gains are needed for CIVs. The adaptations are discussed in detail below.

Special regime for offshore CIVs and companies held by CIVs

Background

Under existing UK law, non-UK residents are only subject to tax on gains on direct disposals of UK residential investment property, if they are dealing in UK land, or if the property is used in a trade they carry from a UK permanent establishment. From 6 April 2019, all non-UK resident persons (with certain limited exemptions) will be subject to UK tax on gains on direct disposals of investments in all classes of UK land and disposals of rights or interests in entities that, directly or indirectly, derive at least 75% of their gross asset value from UK land and are therefore UK property rich (‘indirect disposals’). Generally only investors with at least a 25% ownership interest will be subject to tax upon an indirect disposal (this 25% requirement includes connected persons) although this exemption will not apply where the disposal has an ‘appropriate connection’ to a CIV (whether onshore or offshore). As a result, even a minority non-UK resident investor will be within the scope of UK tax on gains on direct and indirect disposals of investments in a CIV which is UK property rich (though HMRC may face challenges in collecting taxes from these investors where they have no UK presence, and are unaware of these rules).

This change represents a paradigm shift for investors in the UK real estate market. Our previous summary of these fundamental changes can be found here.

What is a CIV?

The definition of a CIV is broad, covering the following entities:

- A Collective Investment Scheme (CIS, as defined in Financial Services and Markets Act 2000 (FSMA))
- An Alternative Investment Fund (AIF, as defined in the Alternative Investment Fund Managers Regulations 2013)
- A UK Real Estate Investment Trust (UK REIT)
- A non-UK resident company meeting the ‘property income condition’

Broadly the property income condition is targeted at but is not limited to the foreign equivalent of a UK REIT as it requires the company to be non-close and derive at least half of its income (and distribute all or substantially all of it on an annual basis) from the holding of long term property investments, and that the company is not liable to tax on that income where it is resident.

Recently published draft HMRC guidance states:

- ‘long-term investments’ means letting property shown as a balance sheet asset
- the annual distribution requirement can be imposed by law, prospectus commitments, or derived from established practice
- ‘substantially all’ in the context of the distribution condition means around 90%
- ‘not liable to tax’ means, the entity is exempt from tax on that property income due to (i) rules which pass that tax burden onto investors in the entity, or (ii) being otherwise exempt from tax or subject to tax at a nil rate.

Certain offshore property companies could inadvertently fall within the property income condition (e.g., Jersey or Guernsey tax resident companies). In practice, it should be possible to manage CIV treatment by including appropriate wording on distribution payments in constitutional documents and marketing materials, and adopting an appropriate distribution policy.

Under this definition, there will be some impact of the rules for UK resident CIVs, for example, non-resident investors in UK REITs will be subject to UK tax on REIT share disposals even where their ownership is below 25%. For the most part, however, the impact will be in relation to offshore CIVs, as set out below.
How will offshore CIVs be taxed?

There are three broad tax treatments which may apply for offshore CIVs falling within these new rules:

1. Default treatment
2. Transparency election
3. ‘Exemption’ election

For these purposes ‘offshore’ means non-UK tax resident or, for co-ownership arrangements, established under non-UK law.

CIV partnerships will remain ‘transparent’ for UK tax purposes under each of those broad tax treatments.

1. Default treatment

This will apply to any offshore CIV that is UK property rich and not constituted as a company or partnership.

Under the rules, subject to certain elections being made, offshore CIVs in non-corporate form such as Jersey Property Unit Trusts (JPUTs) and contractual arrangements (other than partnerships) will be treated as companies for UK capital gains purposes, with the rights of participants treated as shares (but not ‘ordinary share capital’, ruling out the prospect of the extended substantial shareholder exemption (SSE) on disposals of those entities). As such, they will be subject to UK corporation tax on their chargeable gains from direct and indirect disposals of UK land.

As the ‘default’ treatment imposes a layer of tax at entity level, this would penalise tax exempt investors and non-exempt investors would be exposed to the risk of double taxation of gains unless the offshore CIV is able to make an election for transparency or exemption.

2. Transparency election

The fund manager of an offshore CIV may make a transparency election provided the relevant entity meets the following conditions:

- It is UK property rich
- It is transparent for UK income purposes other than as a partnership (such as a JPUT or equivalent and contractual co-ownership scheme)

The election must be made by notice to HMRC within 12 months of the offshore CIV acquiring an interest in UK land or UK property rich company.

For existing CIVs, the deadline for making the election is 5 April 2020. The election is irrevocable and will continue to apply even where the conditions are no longer met, or the investor base in the CIV changes. If a CIV is not yet UK property rich, it can make this election if it has published a prospectus (as defined) clearly stating the intention to hold 75% of its investments directly or indirectly in UK land.

The election requires unanimous investor consent. For newly created funds, HMRC draft guidance states that investor consent can be assumed where fund documentation or other materials makes it clear that the fund intends to make a transparency election. For pre-existing funds, the draft guidance states that investor consent can be evidenced in any form, including emails, notes of telephone calls or in writing.

The effect of the election is to treat the CIV as a partnership for UK capital gains purposes such that any gains arising at CIV level would be chargeable on its investors, potentially resulting in ‘dry’ tax charges for taxable investors unless they receive distributions to fund their tax liability. Existing investors may also be subject to dry tax charges on gains arising from the operation of partnership rules on dilution of their interests in the underlying assets upon new investors subscribing for units (e.g., on a subsequent closing of a fund or in the case of an open-ended fund which issues units on demand).

Underlying entities held beneath the CIV would retain their usual UK tax treatment unless they qualify for, and make, elections as income transparent CIVs.
3. ‘Exemption’ election

Eligible funds may also, or can instead, apply for an exemption election. The effect of this election is to provide entity level exemption from tax on direct and indirect disposals of UK land; whereas, investors will become chargeable on investment gains on distribution of realised gains by the fund or when investors sell their interest in the CIV.

A proportionate exemption will be available for companies wholly or partially owned by the CIV structure (subject to a 40% minimum investment condition).

Application to offshore CIVs

The exemption election will be available to offshore CIVs which:

- Are companies or treated as companies under the CIV rules
- Are UK property-rich
- Qualify as a CIV other than by solely being an AIL (e.g., as a non-UK resident company meeting the ‘property income’ condition)
- Satisfy one of the following conditions designed to ensure the entity is diversely held, or owned by institutional investors:
  - Genuine diversity of ownership. Broadly this means that the fund expressly makes a public and binding commitment to market and make available the fund to the specified target categories of investor without limiting investment to a select group of investors by deterring a reasonable investor within the target market from investing.
  - The non-close condition and the recognised stock exchange condition (ordinary shares listed and regularly traded on a recognised stock exchange)
  - The non-close condition and the UK tax condition (such that fewer than 25% of the proceeds on a sale of its shares at market value would fall out of charge to UK tax solely by operation of double tax treaties)

For the above purposes, the non-close condition is met if the entity is not regarded as controlled by five or fewer participators for these purposes. The draft legislation does state that a company will not be close only because of a direct or indirect interest from a qualifying investor (generally institutional investors).

CIS Limited Partnerships (LPs) are qualifying investors for these purposes provided they are not close themselves. Based on published draft guidance, HMRC will not treat these LPs as being close purely due to a general partner having powers to manage the partnership.

It appears that the draft legislation was intended to allow a company to ‘trace through’ to qualifying investors when considering the close company test (an example provided in HMRC draft guidance does state this is possible). Based on the current drafting, however, there is a risk that a company could fail this test where it is held by a close company itself, regardless of any indirect qualifying investor interests. This is on the basis that the company would not only be close due to the qualifying investor interest, but also due to its direct parent’s holdings.

Application to companies held by certain CIS

The exemption regime can apply to a property rich company wherever resident which is not a CIV, but is wholly or almost wholly owned by a CIS which is
either a partnership or an authorised contractual co-ownership scheme (CoACS), provided one of the following conditions is met:

- The CIS owning the company meets the genuine diversity of ownership condition
- The company itself is non-close, and meets the UK tax condition

Breach of conditions for exemption

Failure to meet the conditions for exemption may result in withdrawal of the exemption election and the investors suffering a deemed market value disposal and reacquisition of their interests in the fund with dry tax charges arising. If a breach of the conditions occurs there are 30-day and 9-month grace periods for the fund manager to remedy the breach which may allow the exemption to continue but in the case of a breach for up to 9 months a deemed disposal would still occur.

Fund managers and taxable investors should note, however, that whilst the exemption can continue after breaches, the tax charges triggered by those breaches can remain in place. For example, where following a sale of an asset a CIV is no longer UK property rich due to its having a significant cash amounts, a deemed disposal will accrue to investors. In determining whether a CIV is UK property rich, cash is a ‘bad’ asset, even where it is held temporarily and will be redeployed for further UK property acquisitions.

A distribution of value derived from direct or indirect disposals of UK land would also result in a deemed disposal for investors, with the tax charge arising when the investor becomes entitled to the receipt of value, and the remainder of the deemed gain (if any) chargeable on winding up of the fund.

If the election ceases to take effect (or where a deemed disposal has been triggered in circumstances where the exemption conditions have been breached), tax charges on remaining deemed disposal amounts are deferred for 3 years unless the fund is wound up sooner.

The exemption can be revoked by HMRC for failure to provide information or documents required to HMRC or to ‘safeguard public revenue’. The scope of this power is potentially very broad, though HMRC’s draft guidance states that they will only seek to revoke the election in ‘exceptional circumstances’. The guidance goes onto to say that generally this will only apply where the exemption election has been made as part of arrangements that have tax avoidance as its main or one of its main objects.

Reporting by the manager

The fund manager must comply with reporting obligations in respect of investors’ holdings when the election is made and at periodic intervals, with an investor notification obligation arising when a charge to tax arises. Details of the precise reporting obligations are still to be announced.

Exemption election - example fund structure (UK Property rich fund with some non-UK property holdings)
► On the basis MidCo is not UK property rich, a disposal of its shares by Fund LP is not subject to UK tax (and it also cannot have an exemption election made in respect of it).

► Gains on disposal of UK PropCo 3 by MidCo will be subject to UK tax (but currently exempted under UK / Luxembourg DTT).

► Gains on disposals by UK PropCo 3 are subject to UK tax. An exemption election cannot be made for PropCo 3 on the basis MidCo has access to the UK / Luxembourg DTT (which would currently grant a 100% exemption for disposals of UK property rich entities).

4. Practical considerations

Fund structures will have to be reviewed following these changes – draft HMRC guidance recognises that commercial restructuring needed to meet relevant conditions within the CIV rules will not generally be caught by anti-avoidance rules, though each case will be considered on its own merits.

Below are some key points for investors and funds to be aware of:

► Funds with disposal phases throughout their cycle (e.g., Core, Evergreen) could receive cash balances which lose them UK property rich status. This can trigger dry tax charges for taxable investors. This may make the exemption election less attractive for funds which could regularly move from being UK property rich or not.

► The use of corporate TopCos in joint venture structures may increase the difficulty of obtaining eligibility for the exemption election. This could, however, easily be remedied by including a CIS limited partnership as the ultimate fund entity.

► Where dry tax charges at investor level create a risk for funds using either the transparent or exemption election, it may be necessary to amend constitutional documents to allow funds to be repatriated to investors.

► Funds which may not currently fall within the definition of a CIV may want to consider restructuring to fall into the regime – this may result in having to balance the commercial impact of UK tax being borne at fund level against the impact for investors in losing their 25% minimum holding threshold for tax on indirect disposals. Whether this type of restructuring triggers anti-avoidance legislation would be determined on a case by case basis.

► Investors, fund entities and sub-holding companies based in jurisdictions which do not give the UK taxing rights on indirect disposals of UK land (e.g., Luxembourg, based on the current DTT) could prevent the exemption election being available to funds depending on their ownership interests.

► Going forward, funds and investors are likely to conduct increased due diligence before investing in structures and accepting investment in structures. Increased demands for information on both sides, should be expected.

► Where income transparent entities (e.g., JPUTs) sit within fund structures subject to the exemption election, it may still be useful to make transparency elections. For example, exempt investors will likely want to invest in a transparent JPUT to eliminate UK tax on capital gains at entity level.
What is next?

HMRC also intend to release separate secondary legislation which enables fund managers of a CIV fund to operate withholding tax in relation to investor gains. It will also provide a reporting mechanism to ease the administrative burden for taxable investors. However, recently published HMRC guidance does not contain any information on this withholding mechanism.

These new rules are complex. Managers of existing and proposed new funds should consider them immediately to analyse the impact on funds and investors and determine what steps are necessary prior to the changes taking effect from 6 April 2019. The EY team can advise on restructuring options and the making of elections to come within the transparency or exemption regimes as necessary.

Further information

Your usual EY contact will be able to provide you with additional information, otherwise please feel free to contact any of the following people in the real estate tax team:

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