Practice guide

Tax transparent property funds

Speed read

The article considers the extent to which investors in certain property fund vehicles that are transparent for tax on income are also treated as if they held underlying property directly for other UK taxes. The fund types are UK partnerships, offshore unit trust schemes and co-ownership authorised contractual schemes. The taxes concerned are SDLT, equivalent devolved taxes, CGT and, more briefly, capital allowances and VAT. Two case studies track the effect of introducing new money into existing structures. The article also notes the possible introduction of a new type of tax transparent property fund for professional investors.

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Tax transparent property funds (TTPFs) come in different forms. Two forms are very common: UK partnerships and non-UK unit trust schemes. Another form, co-ownership authorised contractual schemes (ACSs), is relatively new but, we estimate, may already have acquired £7bn of UK real estate. There are other types of TTPFs, such as non-UK partnerships, exempt unit trust schemes formed in the UK and partnership-based or non-UK contractual schemes, but these are rarer and are not considered further here. References below to partnerships are therefore to English limited partnership, Scottish limited partnerships or UK limited liability partnerships. And references to unit trust schemes are to those formed under non-UK law, usually in Jersey.

Partnerships offer great flexibility but they are most often used for closed ended, fixed term co-investment. Unit trust schemes have been hugely popular as single asset holding vehicles and may be seen as more tradeable than partnerships. ACSs may offer investors better liquidity than the other two forms since ACSs need to be open-ended (FSMA 2000 s 261E). That said, ACSs are for qualified investors only and so do not need to offer short notice redemptions as required of retail funds (and even that requirement is subject to suspension and indeed current consultation by the Financial Conduct Authority; see *Liquidity mismatch in authorised open-ended property funds* (August 2020) consultation paper at bit.ly/3cFR1yZ).

Tax transparency

From the perspective of UK tax on income, transparent funds have an obvious appeal. They offer investors the income tax treatment that they would have if they owned the underlying assets directly, whilst allowing access to the commercial benefits of being in a fund, such as reduced cost, specialist management expertise and risk sharing. The interposition of the fund does not introduce a layer of direct tax. This is as much valued by taxable investors concerned that income is not taxed twice as it is by exempt investors (such as pension schemes, life companies carrying on pension business, charities and sovereign wealth funds) not expecting income to be taxed at all.

In large part, therefore, there may be no great debate about whether tax transparency for income is desirable. Likewise, as long as the unit trust deed is appropriately drafted (*Baker* v *Archer-Shee* [1927] AC 844) and pension schemes do not invest in limited liability partnerships (FA 2004 s186(2)), there should be no serious doubt about whether transparency of tax on income will actually be achieved.

On the face of it, the picture looks equally simple, if the other way round, for SDLT. By 'SDLT', we also mean land and buildings transaction tax (LBTT) and land transaction tax (LTT) except where stated otherwise. For SDLT, transparency tends to increase tax cost. If the TTPF is a partnership, which is largely transparent for SDLT, SDLT is payable on any secondary trades in the TTPF, but this is the not case with unit trust schemes or ACSs, which are opaque for SDLT.

The SDLT treatment, and whether the TTPF is authorised and is formed in the UK, can be key features (see table 1).

Table 1: Key features of tax transparent property funds

Tax transparent property funds	No requirement to be authorised	Formed under UK law	Units tradeable without SDLT
Partnership	✓	✓	×
Unit trust scheme	✓	×	✓
Co-ownership authorised contractual scheme	×	✓	✓

Partnerships

SDLT

However, there are aspects of the tax treatment that repay a closer look, including examining how far the principle of partnerships being transparent applies to SDLT.

The purchaser of an interest in a 'property investment partnership' (PIP) is taken to enter into a land transaction for consideration equal to a proportion of the market value of relevant property held by the partnership (FA 2003 para 14 Sch 15). The proportion is determined by the income profit share acquired (FA 2003 para 34(2)

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Sch 15). The value taken is the gross property value rather than net of debt. In a partnership geared up with lending therefore, the consideration actually paid for the partnership interest might be a lot less than the value giving the measure of the SDLT charge. The effective rate of SDLT, taken by reference to the equity price paid for the partnership interest, can therefore be a lot higher than the normal 5% rate for asset acquisitions. This is perhaps technically no different from an asset deal where stapled debt is taken on by the purchaser, but such a deal structure is unusual for an asset deal.

A purchaser of a partnership interest might also be disappointed that the full range of SDLT reliefs is not available. In particular, purchasers of residential property could qualify for a reduced rate of SDLT under multiple dwellings relief (FA 2003 Sch 6B), which is particularly beneficial during the current SDLT holiday running until 31 March 2021 (SDLT (Temporary Relief) Act 2020) and for purpose-built student accommodation (which is not within the 3% surcharge regime for residential property; FA 2003 Sch 4ZA para 18(7)). But the relief is not available for acquisitions of partnership interests (HMRC's *SDLT Manual* at SDLTM29920). Unit trust schemes used to be able to claim seeding relief on direct property acquisitions (FA 2003 s 64A) but, in the view of HMRC at least, could never do so on transfers of partnership interests. HMRC have likewise said that transfers of partnership interests cannot qualify for relief on seeding ACSs (FA 2003 Sch 7A para 10).

There are occasions therefore where the purchaser of a partnership interest pays more SDLT than someone acquiring property directly. However, it can be the other way round sometimes. There is generally no SDLT on the acquisition of an interest in a partnership which is not a PIP; that is to say, a partnership that does not invest or deal wholly or mainly in chargeable interests (FA 2003 Sch 15 para 14(8)). Buying a partnership carrying on a housebuilding business may therefore not be chargeable (SDLTM34010). And, as a result of devolution, the meaning of 'chargeable interest' is now confined to land located in England and Northern Ireland (FA 2003 s 48). The acquisition of a partnership holding, say, predominantly Scottish property and a small amount of English property should not attract SDLT therefore, just LBTT on the Scottish element. The definition of 'chargeable interest' under the equivalent test in Scotland includes any property worldwide (LBTT(S)A 2103 Sch 17 para 31(2)), so LBTT still applies where, as is much more common in the UK, the majority of the portfolio is English properties with only one or a few in Scotland. It is the same in Wales in relation to LTT (LTTADA 2017 Sch 7 para 33(3)).

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There is also some debate about whether investments in other PIPs held by a partnership count as chargeable interests. If this is not the case, it might mean an interest in a double tier of partnerships would be outside the scope of SDLT. HMRC's view however is that the principle of transparency extends far enough to look through the bottom partnership such that that top partnership is deemed to hold the underlying real estate, and hence a chargeable interest (FA 2003 Sch 15 para 2).

Where we can see more divergence from complete transparency is if, instead of taking an assignment of an existing partnership interest, an investor subscribes new equity into a partnership. Although this counts as

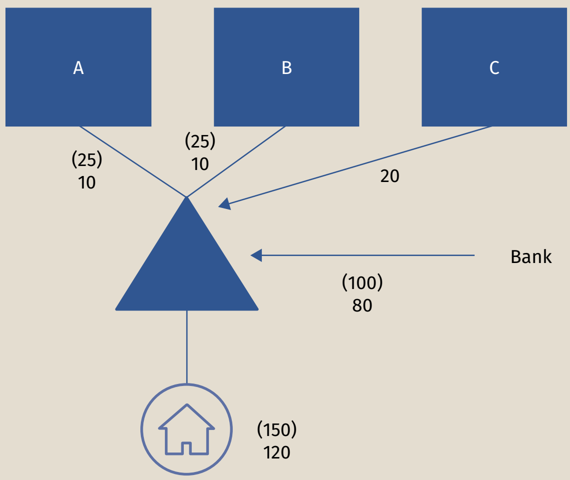
Partnership case study

A and B set up a partnership, each making a contribution of 25. The partnership then took bank borrowing of 100 and bought English commercial property for 150.

Recently, the value of the property has fallen to 120 (reducing A and B's equity value to 10 each) and C is brought in to rescue the partnership from a breach of its 'loan to value' covenant. C therefore contributes 20, applied by the partnership to reduce bank borrowing. The result is that A, B and C's net equity values, the property value and the bank borrowing stand as shown opposite (with original values in brackets).

C accordingly effectively owns half the property, which has a gross value of 60 and net value of 20. C asks which of these two figures determines SDLT cost and capital gains basis, and is surprised when told that it may be neither.

It is indeed true that the potential exposure to SDLT is on half the gross value of the property (so, 60 rather than 20). However, there is a complex but coherent regime for dealing with changes of partnership shares. C's admission counts as a transfer of a partnership interest but is classified as a 'type B' transfer if the investment made by C is entirely to be spent on debt or otherwise put to use by the partnership (FA 2003 Sch 15 para 14(3C)). In the case of a type B transfer, property is only taken into account in calculating the charge if acquired from a partner or someone connected with a partner (FA 2003 Sch 15 para 14(5A)). As the partnership



acquired its sole asset in the market, there is no partnership property on this test, and hence no SDLT.

For the purposes of tax on capital gains, C will acquire half the property on a no gain/no loss basis. As such, half of A and B's original base cost will shift to C, and C will have base cost of 75 (rather than its gross equity value of 60). This is provided that there has been no revaluation of the property in the partnership accounts prior to C's admission.

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a transfer of a partnership interest (FA 2003 Sch 15 para 36), there is only a charge if consideration is given. The mere subscription of money into a partnership should not count as giving consideration for these purposes. As the partnership case study (previous page) seeks to show, a secondary closing into a partnership (i.e. where further money is introduced into a fund and existing investors do not take out value) may therefore not attract SDLT.

> The population within scope of capital gains tax increased on 6 April 2019 with the introduction of non-resident capital gains tax on commercial property

UK CGT

Turning now to the taxation of capital gains for partners subject to UK tax, a similar overarching principle of transparency applies but the legislation is strikingly more succinct. Assets held by partnerships are simply treated as acquired and disposed of by its partners in proportion to their respective partnership shares, and not by the partnership (TCGA 1992 ss 59, 59A).

But shorter legislation has entailed longer guidance, seen in HMRC's long established Statement of Practice D12 (SP D12). This recognises that a disposal occurs when new partners are admitted – or partnership shares change for other reasons such as profit hurdles or redemptions – but generally tries to prevent this triggering a charge (SP D12, para 4) as long as there is no revaluation (SP D12, para 6) or payment to other partners (SP D12, para 7).

However, the corollary of the existing partners not realising a gain (or loss) is that the investor inherits a proportion of existing base cost for UK CGT purposes rather than their base cost being linked to the value of the property at the time of subscription.

(See the partnership case study on the previous page for a worked example.)

Unit trust schemes

The greater likelihood in the current market that scenarios of this kind may occur is not the only reason why advisers may have to brush up on SP D12. The population within scope of capital gains tax increased on 6 April 2019 with the introduction of non-resident capital gains tax on commercial property. Further, SP D12 is now more widely applicable because of a law change connected to that extension of capital gains tax.

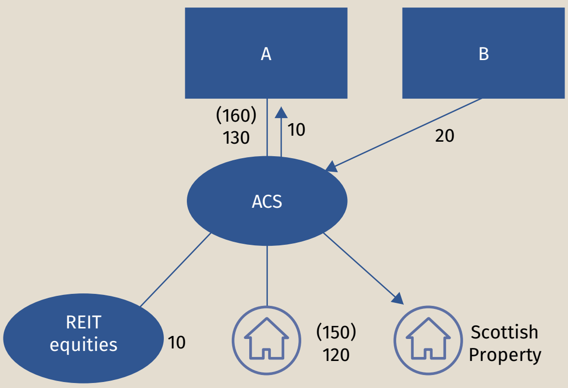
Whilst the default position remains that unit trust schemes are treated as companies and are therefore opaque for CGT (TCGA 1992 s 99 and Sch 5AAA para 4 in relation to the indirect charge on non-resident persons), unit trust schemes may, by election, now be treated as partnerships for CGT (TCGA 1992 Sch 5AAA para 8). This change means, in unit trust schemes, we now have a TTPF offering transparency for both income and capital gains tax and opacity for SDLT.

But the attraction of that combination is perhaps not always irresistible. Transparency can be seen as burdensome for investors in a moderately or very active unit trust, who may not welcome reporting and potentially paying tax on every asset disposal, particularly if 'dry tax' occurs because the TTPF prefers to reinvest rather than distribute proceeds of sale. In recognition that transparency is not every investor's preference, the transparency election

ACS case study

Two years ago, A seeded an ACS with English property then worth 150 and more liquid investments, some REIT equities, worth 10. The market value of the property has now dropped to 120 (the equities continue to be worth 10), and accordingly the value of A's units is 130.

B now subscribes 20 into the ACS, of which 10 is used to buy Scottish property and 10 to redeem A's units (as shown below).



The parties ask how these payments are treated for capital gains tax, SDLT and LBTT.

The treatment of the 20 paid by B is very straightforward. B acquires a capital gains tax base cost of 20 in the units and incurs no SDLT.

As regards the 10 spent by the ACS in the market, this will attract LBTT. The ACS should be warned that buying Scottish property creates risk of some double LBTT since a future purchaser of units in the ACS would, under current law, also incur a proportionate amount of LBTT on its own acquisition.

The payment of 10 to A will cause partial clawback of SDLT relief claimed by the ACS two years ago. This is because, following the redemption, the value of A's holding is below the 150 value of the units issued to A in respect of seeded property (FA 2003 Sch 7A para 17(3)(4)). Originally, the units issued to A for REIT shares created a buffer from the clawback (since the total value of A's holding was 160), and in more usual times this would have been added to by growth in market values. Unfortunately, the declining property market has consumed the buffer in this case. This may be a rare example of tax exposure rising as the market falls.

A will make a disposal of units for 10. Despite the recent poor return, the disposal could still trigger a gain as A may have rolled over prior property gains when it seeded the ACS (TCGA 1992 s 211B). That may have occurred if, in common with many of those who have founded the ACSs, A is a life insurance company holding the assets for its 'long-term business' (as defined in FA 2012 s 116(2)).

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requires consent of all unitholders. Additionally, the new capital gains tax legislation permits unit trust schemes (and other collective investment schemes and vehicles) to opt into a tax exemption model instead (TCGA 1992 Sch 5AAA para 12), although the qualification criteria is significantly more stringent (TCGA 1992 Sch 5AAA para 13).

There is also some downside of opacity for SDLT. The fact that a unit trust scheme is taken to be a company separate from the unitholders means that, compared to say a partnership, greater SDLT is generally due on establishing a unit trust scheme with seed assets or on the extraction of assets from a unit trust scheme. Seeding relief for unit trust schemes is, as mentioned above, now repealed (FA 2006 s 166(2)) and the fiction of unit trust schemes being companies does not extend as far as their being entitled to SDLT group relief (FA 2003 s 101(7)).

Co-ownership authorised contractual schemes (ACSs)

The ACS may hold some answers where unit trust schemes do not. For capital gains tax, it is effectively exempt since it is not within the charge to corporation tax (CTA 2010 s 1121(1)), whilst its unitholders are taken to own the units not the underlying property (TCGA 1992 s 103D(3). The use of an ACS can also bring corporation tax advantages on seeding, such as the sharing of indexation allowance across all properties.

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Further, an ACS could offer the best of both worlds for SDLT. An ACS may effectively be transparent when established if it qualifies for seeding relief but opaque for later investors (FA 2003 s 102A). However, seeding relief is subject to a number of conditions and, in particular, a clawback rule affecting redemptions by the founding investors arranged within a three year control period (FA 2003, para 17 Sch 7A). The ACS case study (opposite) explores that rule.

ACSs, as yet, do not get the same treatment in Wales (where there is no seeding relief for LTT) nor in Scotland (where, additionally, units in ACSs are still looked through for the purposes of LBTT).

(See the ACS case study opposite for a worked example.)

VAT and capital allowances

Administratively, it would be undesirable for a TTPF to be transparent for VAT. Happily, it is the TTPF, rather than the investors, which is typically treated as making any supplies of the property. Accordingly, it is the TTPF that would opt to tax the property and register for VAT. However, depending on the type of TTPF, this may effectively be through its general partner(s) or trustee(s) etc.

With capital allowances (both in respect of plant and machinery and structures and building allowances), a similar position applies in relation to partnerships, and the partnership is the person entitled to allowances. But there is no consensus on whether allowances belong to a unit trust scheme or its investors and best practice may be, on the sale of units or underlying property, to make elections under CAA 2001 ss 198 and 199 at the level of both the trust and unitholder. The position is clearer with ACSs, where legislation now provides for the ACS to elect to be treated, in effect, as if it were entitled to the allowances in the first instance, such allowances then being allocated to investors on a just and reasonable basis (CAA 2001 ss 262AA–262AF, ss 270IC–270IF; SI 2019/1087). This regime does though impose tax written down value on certain transfers rather than permitting a s 198 or s 199 election to fix entitlement.

We can therefore summarise the extent to which TTPFs exhibit transparency across three key real estate taxes in the following table (table 2).

Table 2: Extent to which TTPFs are transparent

Extent that tax transparent	CGT	SDLT	Capital allowances
Partnership	Transparent but subject to SP D12 'code'.	Transparent but subject to rules in FA 2003 Sch 15 Part 3.	Partnership treated as person entitled to allowances.
Unit trust scheme	Transparent as partnership but only if TCGA 1992 Sch 5AAA para 8 election made.	Opaque, so no charge on acquisition of units.	Uncertain. Ensure analysis followed is consistent with both views, in particular on sale of properties or units.
Co-ownership authorised contractual scheme	Exemption regime applies instead, so only charge on unit sales.	Opaque, so no charge of acquisition of units, except in Scotland.	By election, may be administered at fund level, but entitlement at investor level.

Conclusion

The government announced in March that it is undertaking a review of the UK's funds regime. In response, industry has proposed a new form of TTPF for professional investors (a 'professional investor fund' as set out in *Professional investor fund* (The Association of Real Estate Funds), March 2020; see bit.ly/30jfaX9). This would be a UK domiciled, unauthorised and SDLT opaque vehicle, and would therefore look to tick all the boxes in table 1. But it would in large part borrow from existing forms, notably ACSs, including with regard to tax rules. This possibility, combined with other factors, means that the taxation of TTPFs (including the extent to which different TTPFs deliver tax transparency, as summarised in table 2) will remain a focus for advisers to real estate investors. Those other factors include the extension of the scope of capital gains tax on non-residents, a possible drop in asset values (as illustrated in the case studies), and the related recapitalising and reweighting of property exposure. ■

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- UK asset holding company consultation: the thick end of the wedge (Andrew Howard, 1.4.20)

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