Dealing in land

JULIE BUTLER considers some of the inheritance tax business property relief implications for development land and transactions relating to valuable property.

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With so many property development opportunities facing landowners in the UK it is important for tax advisers to understand what qualifies as a trading company and what qualifies as a company 'dealing in land' for tax purposes. Part of this review must be to consider the most tax-effective business structure for development land. Whether the ordinary shares in a company dealing in land are eligible for inheritance tax business property relief is a moot point.

As an example, consider a director who has sold farmland with development potential to a limited company, DevelopCo Ltd, for an issue of shares and cash due to him on loan. Such a transfer could qualify for the lower 10% rate of capital gains tax under entrepreneurs' relief on the basis that the land was a trading asset and the farming business had ceased. The cessation is a separate subject and, as always, care must be taken to ensure that all conditions are met to achieve all tax relief.

Subsequently, the land is to be developed with a builder so that two properties will be constructed on the land, and the sale proceeds will be divided between the company and the builder as agreed between them. When considering the possible availability of inheritance tax business property relief for the shares in the company, it is important to appreciate that this is not simply intended for trading companies, as is often supposed. Instead, it is a relief for businesses as long as they do not fall within various exclusions, one of which is a business of dealing in land or buildings. Dealing in land is a trading activity for tax purposes, but it is excluded from the scope of business property relief.

KEY POINTS

- The importance of differentiating trading companies and dealing in land.
- Do not overlook the capital gains tax and other implications of property transfers.
- When will inheritance tax business property relief be available on shares in a land development company?
- Care is needed to ensure that the activity should not be regarded as a 'fake land' dealing activity.
- Shares in a property development company should qualify for relief.

What is dealing in land?

There are no reported court decisions on what constitutes a business of dealing in land or buildings for the purposes of business property relief. What can be said is that a company that acquires land with a view to selling it on after it has appreciated in value, perhaps after the grant of planning permission, will be a land dealing business and excluded from this relief. However, a building company that operates a business of constructing houses or other properties for resale – in other words, a property development company – will qualify. Such understanding is confirmed by HMRC's *Inheritance Tax Manual* at IHTM25266:

'This restriction does not deny relief for a business ... which, at the time of transfer, is carrying on a genuine building and construction business holding a number of properties (eg houses or plots awaiting development) as stock in trade.'

In our example, DevelopCo Ltd falls between these illustrations of a building company and company that deals in land because it does not simply acquire land to resell at a profit, but nor is the company itself carrying on construction activities. Instead, DevelopCo Ltd has arranged for properties to be constructed on the land that it owns. Although it retains a degree of control over the process under the building agreement, it is not responsible for the construction activity. The building agreement states that it is neither a partnership nor a joint venture agreement and it also makes it clear that all the risks involved in the construction work are taken on by the builder, not the company.

Once the developed plots are sold, DevelopCo Ltd will receive a fixed sum that is broadly in line with the cost of the plots. The builder will then receive a tranche of the sale proceeds to the extent of its construction and development costs. The remaining balance of the sale proceeds is divided equally between the company and the builder.

The question that has to be asked is, if the shareholder dies, is there enough risk and trading activity for the DevelopCo Ltd shares to be eligible for business property relief?

The decision in *Piercy*

Under the agreement in our example, it is clear that the company does no development work itself; however, this need not affect the inheritance tax position. Further, a business can employ an agent or third party to carry out work on its behalf or provide services, but this need not be done by the staff of the business itself, although the position is more robust if it is. This point was confirmed in *Executors of Piercy (deceased) v HMRC* [2008] SSCD 858, concerning a property development company, Temple Lodge Ltd, which also held investment assets. The Special Commissioner made this point:

'I should mention that the building work was always subcontracted, but this in no way derogates from the trading and developer status of Temple Lodge.'

In *Piercy* it was also stated:

'Equally it follows ... that a company whose business it is to acquire land with a view to promoting a development, and then realising the developed land once subcontracted building work has been completed, is also not a "land dealing company" for the purposes of the s 105(3) definition. The only type of land dealing company whose shares fail to qualify for the relief is thus some sort of dealing or speculative trader that does not actively develop or actually build on land.'

This was a decision of the Special Commissioners, and it is therefore of persuasive rather than binding authority. Nevertheless, it is generally accepted as a correct decision. The only difference between DevelopCo Ltd and Temple Lodge Ltd is that the latter subcontracted the building work, whereas our company transfers all the financial risks of the development onto the builder.

Commercial risk of development

Under the agreement in our example, the conditions are that if the plots fail to sell or do not achieve the anticipated prices, it will be the builder who loses money rather than DevelopCo Ltd. However, there is no suggestion in *Piercy* that the conclusion reached depended on Temple Lodge bearing all the risks of development. Nor does the inheritance legislation incorporate any such test. If DevelopCo Ltd secured a great deal with the builders it is perfectly arguable that this is not relevant to the question of whether its shares are eligible for business property relief. In the final analysis, DevelopCo Ltd acquired land to have houses built on it before selling off the sites. That activity should not be regarded as a 'fake land' dealing activity and business property relief should therefore be available because the company has been carrying on a construction activity.

The tax planning action point is that, to make a future claim for inheritance tax more robust with regard to the development of land, the house building should form part of DevelopCo Ltd's activities. For example, to build the houses with some risk factor as to profitability has more strength. It can be argued that a joint venture with the builder would support a greater emphasis on trading than the agreement where it is only the builder who takes the risk. The ultimate protection is the building of the houses by DevelopCo Ltd itself.

Further, it can be argued that there are similarities with the need to trade in a building activity and the need to trade in a farming activity. Greater strength is achieved through the evidence of risk and involvement.

Sale of land for development

The risk of shares in a development company being excluded from business property relief leads landowners to consider other ways of dealing with the development potential on land, perhaps by selling it to a third-party developer.

Instead of the landowner/director transferring the land to DevelopCo Ltd, a sale of the land to a developer could also achieve the 10% rate of capital gains tax through entrepreneurs' relief. The advantage of this transaction is that a capital gains tax disposal is made without the fuss of a limited company interaction and the work associated therewith. If the entrepreneurs' relief claim were to fail, from 6 April 2016 there is the 20% rate of capital gains tax. All tax planning around land sales and property development must be 'considered in the round' and looked at in depth and tailored to the circumstances.

With the current advantageous rates of capital gains tax of 10% or 20% on sales of potential development land, the decision for the farmer or landowner to move land into a property development company can have associated tax risks compared to a direct sale.

Potential development land

On the subject of the inheritance tax relief on potential development land, if the landowner should die before the land is sold to the developer, the relief on the development potential (hope value) at the date of death must be considered. If the land is part of a farming partnership that is trading and the land is used in the trade, business property relief should be achieved on the hope value. The question is whether the land is 'partnership property' or is simply used by the farming partnership. Potential development land that is *not* partnership property achieves only 50% business property relief for inheritance tax (IHTA 1984, s 105(1)(a)).

The recent case of *Ham v Bell and Other* [2016] EWHC 1791 has highlighted the need to distinguish between the land and other assets used in a partnership. The key action points are as follows.

First, to establish whether potential development land is partnership property or assets used in the business.

Second, to consider whether the land should be sold to a developer and subject to capital gains tax or be developed as a part of a trade.

Finally, if the trade is carried out through a limited company to establish whether this is dealing in land or a building company. ■

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