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Arrested development

Clients owning land with potential development value may fall into the trap of doing nothing with it but, says **Julie Butler**, this could lead to significant problems with securing future inheritance tax reliefs

All land and most buildings contain a degree of potential development or "hope" value – that is, some opportunity to build houses, improve existing buildings, or convert barns. The problem is how to protect this value to ensure inheritance tax (IHT) relief is achieved on either the potential value or the development proceeds.

If the potential development asset is held within a business, such as farmland within a large working farm, the owner may be tempted to obtain planning permission and then do nothing about it from a tax planning viewpoint. However, once permission is obtained, the hope value of the land is realised, leading to a leap in value – if this happens before the owner dies, the value of their estate for IHT purposes can increase very substantially, and any cash or binding contract for sale would not qualify for business property relief (BPR). This is for one of two reasons. First, the surplus cash from the sale of the development site might be regarded as an excepted asset, so the value of the business attributable to the value of the cash would not qualify for BPR. Second, and worse still, one needs to be careful, if the proceeds are substantial, not to use them in such a way as to change the existing business into one that is mainly an investment business. There could be a nightmare situation where all relief is then lost.

To avoid such a situation, the owner could reinvest the cash proceeds in other farmland or businesses which would qualify for BPR. There is case law to support the proposition that the cash would not have had to be reinvested at the time of the landowner's death in order to avoid being an "excepted asset", so long as there was a credible plan for reinvesting it in a manner which qualified for BPR. There would have to be clear documentation of this intention.

However, there are considerable practical and commercial obstacles to reinvesting that amount of money from a large development within a relatively short timescale. This is because, from a commercial perspective, it would be sensible to stay with the businesses that the landowner (or people the landowner trusted to delegate the management of a business) understood and could manage. This might mean that the only option would be farming, and it might not be easy to acquire land of sufficient quantity and quality, in the right location, and at a sensible price, for it to be incorporated effectively into the same business. And even if it were possible, the landowner might not have the energy to manage such a greatly expanded farming enterprise, begging the question of who would do so instead. This leaves a substantial risk of an IHT charge at 40% on the full amount of any realised development value, to the extent that that that value was not reinvested in qualifying assets.

One option in these circumstances would be for the landowner to make gifts of potential development land to the next generation during their lifetime. Those gifts would be liable to capital gains tax (CGT), at a lower tax rate of 18% or 28% unless a holdover election were made. The gifts could also be made at a much lower market value, because they could be given before the hope value of the land was realised.

However, this approach may not actually have as many advantages over "doing nothing" with the potential development land as it seems. If the owner does nothing, they make no actual or deemed disposal of an asset during their lifetime, so will incur no CGT liability. Their estate will then obtain the benefit of the CGT-free step-up in base cost, under section 62(1)(a) of the Taxation of Chargeable Gains Act 1992 (TCGA 1992), so if their personal representatives choose to sell part of the land, they are more likely to realise a smaller gain, and suffer a reduced CGT liability. Alternatively, the personal representatives could pass on the higher base cost when they assented the land in favour of persons who took the land as legatees (whether absolutely or as trustees of the settlement), under section 62(4) of the TCGA 1992.

With regard to IHT planning, both approaches – "doing nothing" or lifetime giving – have benefits and risks

If it can be predicted that the landowner would die before the realisation of the hope value, then the "do nothing" approach might lead to a lower overall tax burden: the development land should qualify for agricultural property relief (APR) and BPR, even in respect of the hope value, and the landowner and legatees would obtain the benefit of a market value base cost at the time of the landowner's death. It is assumed that this will be considerable. However, the date of death cannot be anticipated, so this is a risky approach to take.

With regard to IHT planning, each approach – "doing nothing" or lifetime giving – has benefits and risks, and both should be considered carefully before reaching a decision. With IHT coming under review, the possibility of lifetime transfers has to be considered where any potential development land is involved. ■

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