Development Land - Strong Planning Needed For Entrepreneurs' Relief Purposes

Julie Butler looks at some tax planning points and potential pitfalls in respect of development land.

The UK needs to build a substantial number of houses to cope with current and future demand. The land available will be a mixture of farmland and other general land (e.g. redundant land and land used in a business). There is a need to put strong planning in place to achieve capital gains tax (CGT) entrepreneurs' relief (ER).

For most projects a well-planned 10% rate of ER or rollover relief for CGT purposes are the goals. However, the achievement of these reliefs together with full inheritance tax (IHT) protection can be a complicated matter.

It is suggested therefore that ER planning and IHT planning surrounding potential development land should be reviewed as a matter of urgency.

Failure to qualify for ER relief

The fundamental rules of ER are that land must be used in a trade, with the 'badges of trade' clearly evidenced for at least one year before disposal.

Relief may be restricted if there are periods of non-business use, so transfer to new ownership needs to be considered.

The following potential development land will not qualify for ER and rollover relief:

- redundant land;
- land that is let and not used in a trade;
- land with insufficient trading activity; or
- land that is used in an uncommercial trade.

The recent case of Blaney (*E Blaney* [2014] UKFTT 1001 (TC)) emphasises that the land must not be held just 'for pleasure' in order to achieve CGT reliefs (this case concerned business asset taper relief (BATR) as opposed to ER). For IHT purposes, land not owned by a partnership or limited company (i.e. owned outside of the trading vehicle) can only achieve 50% business property relief (BPR) for IHT purposes.

Examples of areas vulnerable to attack by HMRC on the grounds of insufficient trading activity are:

- 'fake' trades put in place just to achieve tax reliefs;
- DIY liveries without service;
- weak contract farming arrangements (CFA) without real involvement by the landowner (i.e. the landowner must have 'their head in the arrangement'); and
- weak grazing agreements.

Legal agreements

The exact ownership must be ascertained by a lawyer – often what the landowner understands to be the ownership structure might not be mirrored by the legal interpretation. The available CGT reliefs that can be used must be reviewed at an early stage. If the land is to be passed to the next generation then holdover elections can be considered, but at the potential expense of the 'tax free' CGT uplift on death of the base cost.

The question of the best use of holdover relief, ER and rollover relief must be examined. Many advisers are promoting the 'front loading' of ER (i.e. take the maximum limit whilst it still exists), whilst others would advance the rollover option.

'Associated' disposals

Where the trade or the farm is operated as a partnership, but the land is owned by one or more partners personally (although this is not normally advisable for IHT purposes, due to the restriction to 50% BPR), if ER is the more immediate goal, it may be helpful to set up the correct structure in advance. The planning is to structure the sale of the land as an 'associated disposal' where there has been a 'material disposal' of a business.

For a partner, a material disposal is relatively easy to achieve because a reduction in the partner's interest in a partnership share will be recognised as a disposal of part of the business by the partner concerned. Previously, HMRC offered no guidance as to what qualifies as a 'material' disposal. However, the example in HMRC's Capital Gains manual (at CG63995) is a 40% reduction. Finance Act 2015 has now laid down that there must be a reduction in partnership share of at least 5%. There are also new rules related to the entitlements of connected parties.

Such action opens the way for the partner to dispose of the land as an 'associated disposal' qualifying for ER and only having to withdraw from the business and not cease the business as with the disposal of partnership property. The disposal must be made 'as part of the withdrawal of the individual from participation in the business carried on by the partnership', but HMRC accept that this refers to equity participation and not time spent.

One advantage is the partner can continue to be a full-time working partner, and as long as there is a minimum 5% reduction in equity interest there is a partial withdrawal from the partnership. This raises the tax planning consideration of the best interaction of the need for partnership property for IHT purposes, and the very efficient utilisation of the associated disposals rule for CGT purposes. With the possible lack of partnership agreements there is a chance that the exact ownership of the land is not known and this must be sorted immediately.

'Slice of the action' schemes

One area of attack by HMRC is any arrangement involving the landowner that can be deemed to be 'slice of the action schemes' to try and capture some of the profits as being subject to income tax.

In general terms, the 'slice of the action' scheme is where the vendor is to receive an agreed percentage of the future development profits. The initial consideration is for the disposal of capital assets, and will therefore generally be subject to CGT. However, the subsequent consideration is for the disposal of a new asset – the right to the contingent consideration (the 'slice of the action') – at a later date. Such a disposal could be caught as subject to income tax because the vendor's rights under the contract were acquired with the sole or main object of realising a gain from the development of the land. The 'slice' will therefore run the risk of being taxed as income at higher rates of income tax (as opposed to CGT at 10% if ER is available).

A very popular arrangement is also for the landowner to receive, say, 'houses' in the development as part of the deal, and HMRC also try to capture this element of the deal as trading income and so taxable at the higher rate of income tax, and therefore disallow ER.

It is important to approach all potential development plans with care as to the logistics and detail, and at an early stage. The legal agreements and the tax protection must be worked out 'hand in hand' with tax planning being sorted at the 'heads of agreements' stage before the legal agreements are finalised.

Consortiums, equalisation and land pooling

An equalisation of values between landowners might be advantageous, and it is important to consider some of the potential tax considerations. There are a range of possible solutions, all of which aim, as far as possible, to share the benefit of the higher value land uses across all involved. There can be considerable benefits for all parties if this can be achieved, not least because it means that the neighbouring landowners will not be in competition for the high value use aspects.

One possibility is demonstrated by the *'Jenkins v Brown'* pooling arrangement. This involves all owners pooling their land, so that they each own a percentage of the whole site.

In many cases, a more simplistic approach may be to use a gross area basis, whereby the landowners agree that the price they each receive will be calculated by reference to the value of the total site. However, this approach can also be difficult where there are numerous owners, more than one buyer, or where the sale of development land is shared over several years. There are other arrangements that involve creating a special purpose company vehicle, into which the land is added and the landowners take shares. There is potential for multiple tax considerations around the disposal of the land to a company. Then extracting the funds requires careful planning with emphasis on values to be agreed.

Another potential strategy is to grant 'cross options', so that if Landowner A sells part of his land, the developer has to pay Landowner B to release his option over the same land. This is a relatively straightforward solution, although it can have disadvantages for both CGT and IHT.

Action plan

These are exciting times for potential development projects, and it is essential to ensure that tax planning strategies are in place early, to maximise the potential tax reliefs available, especially ER. Such tax planning should be in place long before the planning permission has been obtained.

All development projects are different (e.g. ownership, succession plans, etc.). It is essential to ensure that strong, well-understood legal agreements are in place for the trading activity. With regard to development land, there must be a full fact finding exercise to identify the following:

- ownership of land (i.e. that it has been fully researched);
- full trading activity is in operation over the appropriate period of time;
- all legal agreements have been reviewed and refreshed as appropriate;
- accounts and tax return disclosure reconcile to all legal agreements and tax planning;
- succession plans have been considered; and
- act now – time is running out and tomorrow may be too late!

Planning Tip:

The actual proposed sales arrangement/documents should be carefully reviewed as any 'slice of the action' schemes (e.g. share of increased income, receipt of houses) can result in the whole transaction being subject to income tax (*Page v Lowther CA* 1983, 57 TC 199).