Strange rules, beyond understanding

Malcolm Gunn and Fred Butler examine the SDLT complications involved with basic IHT planning for farmers and other trading partnerships.

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One of the enjoyable things about tax work is occasionally being able to save someone a lot of money with one or two sheets of paper. A good example is in relation to IHT business property relief – see ***Example 1***.

This dichotomy in business property rules is somewhat strange and the rationale for it is not clear. But if all the interest in the land is contributed as part of the capital account of the partner concerned, there will be no capital gains tax disposal. Apparently it is acceptable for partnership property to be allocated to one partner only. So the transfer into the partnership may appear to be the easy solution to the inheritance tax issue.

But sadly nothing in tax is that easy. Stamp duty land tax can be something of a spanner in the works, and Mr Moon may be in for a shock. In general, the difficulties are mostly, although certainly not entirely, confined to partnerships which involve non-family members. Any transfer of land into a partnership must take account of the SDLT position and this is far from straightforward as we shall now see.

Partnership shares for SDLT

The first important point to remember is that the measure of a person's interest in a partnership is by reference to income, not capital-sharing ratios (FA 2003, Sch 15 para 34(1)). Whoever thought this was a good idea? This rule is exceedingly strange. It means that the position is not governed by the sensible formula of capital sharing ratios but instead it is governed by the entirely inappropriate formula of income sharing ratios.

And it gets worse. There is no further guidance on the calculation of income profit shares which means that, where different slices of annual profits are shared in different percentages, it will be difficult to determine the SDLT position where profits vary from year to year as they usually do. Presumably one work should work on the basis profit-sharing at the time of the land transfer but that may not be known until long afterwards. So can we work on the latest year's profits? It would be nice to know. Also salaried partners like Mary Anne in ***Example 1*** have to fit into this somehow.

Land within the SDLT partnership provisions

The second point is the definition of 'partnership property' in FA 2003, Sch 15 para 34(1), which is 'an interest or right

Key points

- Inheritance tax solutions may trigger SDLT problems.
- The measure of a person's interest in a partnership for SDLT purposes is by reference to income rather than capital sharing ratios.
- Watch out for aunts, uncles, nephews, nieces and cousins. If they are partners the connected persons rules will not apply and so SDLT may be chargeable on transfers.
- Withdrawal of capital within three years may trigger SDLT charges.
- Watch out for future changes in profit sharing ratios – they could spring a nasty surprise.

Example 1

Mr Moon owns a large acreage of farmland with development potential and a few years ago he set up a farming business with his son Tommy and his niece Mary Anne. She has a slight disability and so works in the farm office as a salaried partner.

Mr Moon holds the farmland as a personal asset in his own name so it will benefit from only 50% IHT business property relief. However if he completes a short declaration of trust to say that the land is henceforth held on trust for the partnership as a partnership asset, it will immediately enable the land to qualify for 100% business property relief. There is no two-year waiting period for the extra relief because that applies to ownership of the business, and not the assets which form part of the business.

held by or on behalf of the partnership, or the members of a partnership, for the purposes of the partnership business'. Originally it was thought that this would bring land held outside the partnership into the scope of SDLT partnership charges and in fact some still hold this view because that is what the legislation seems to say.

Happily, however, HMRC stamp taxes say otherwise. According to the *Stamp Duty Land Tax Manual* at SDLTM33390 they accept that whether a chargeable interest is or is not partnership property for SDLT purposes will be decided in a similar manner as whether or not it is partnership property by virtue of the Partnership Act 1890, s 20.

The basics

Once these points have been taken on board, some simple propositions can be stated:

a) there will be no SDLT liability on land going into a partnership if:
   (i) all the partners comprise either the transferor and/or persons connected with him (within the meaning of CTA 2010, s 1122). If this is not the case, there may be a liability to SDLT, based on a proportion of the market value of the land; and
   (ii) broadly stated, no capital is withdrawn from the partnership by the transferor or (in some cases) a connected person within three years except as represents income profit. This requirement is complex and is analysed in more detail below.
b) there will be no SDLT implications of a transfer of an interest in a partnership so long as firstly, there are no arrangements for this to happen when land is transferred in, and secondly it is not a 'property-investment' partnership. The latter will not normally apply to a trading entity.

Transferring land to a partnership: SDLT

FA 2003, Sch 15 para 10 applies where:

a) a partner transfers a chargeable interest to the partnership; or
b) a person transfers a chargeable interest to a partnership in return for an interest in the partnership; or
c) a person connected with either a partner or with a person who becomes a partner as a result of or in connection with the transfer transfers a chargeable interest to the partnership.

A chargeable interest is transferred to a partnership in any case where a chargeable interest becomes partnership property (FA 2003, Sch 15 para 35).

The formula for 'chargeable consideration' is MV x (100 – SLP)% – another strange rule. This is the rather complicated and bizarre formula which applies only to partnerships and which could well have been drafted by the same person who came up with the unintelligible mathematical formula for net present value of rents. But we don't have to delve into its murky depths because it can be summarised in simple terms.

In effect, the partnership acquiring the chargeable interest must identify what proportion of the chargeable interest changes hands (ie beyond the partnership interest of the transferor or persons connected with him) and it is that proportion of the market value of the interest which is charged to SDLT.

Connected persons under CTA 2010, s 1122 are the spouse or civil partner, relatives of the individual or spouse or civil partner, and spouses or civil partners of such relatives. Relatives are siblings, ancestors or descendants. It will be seen therefore that relatives of relatives are not included and so uncles, aunts, nephews, nieces and cousins are not within any category of connected persons. Hence the problem already mentioned for Mr Moon in ***Example 1*** because Mary Anne is his niece.

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Once the partners in ***Example 2*** and ***Example 3*** have successfully navigated their way through the calculations below, they may think they can breathe a huge sigh of relief and celebrate all their tax planning problems as solved with a large beer, or in Somerset perhaps its scrumpy (an acquired taste). Sadly we have to burst their bubble because they are not out of the woods yet. A liability to SDLT can arise still following the transfer of property into the partnership because of two more strange rules.

Example 2

Mr Berry transfers land worth £10m due some development potential into a partnership consisting of himself, his daughter Maybelline and a Mr Cochran who is to marry Maybelline next month. Mr Berry's health is declining and he is worried about the potential large IHT bill on his death. The land is credited to Mr Berry's capital account in the partnership accounts so none of the other partners have a share in it. However Mr Cochran has a 50% share in the partnership profits, having taken over the main farming work due to Mr Berry's ill health. The SDLT charge is based on the amount of land now treated as owned (via the partnership) by the unconnected person Mr Cochran (as measured by his income share in the partnership), namely £5m at the commercial rates of SDLT to produce an SDLT charge of £239,500. It is not relevant that the land is credited wholly to Mr Berry's capital account.

Had Mr Berry waited until Maybelline and Mr Cochran are married there would be no charge to SDLT.

Example 3

Mr Haley transfers land worth £1.5m to a partnership comprising Mr Haley and Mr Holly. The land is credited to their capital accounts in equal shares and Mr Haley transfers £750,000 to Mr Holly's capital account in connection with the land transfer. They are not relatives. Mr Holly has a 20% share in the partnership profits. The SDLT charge is on 20% of market value (£300,000) and the payment made is not relevant to the charge. The amount payable is therefore £4,500.

Withdrawal of capital

The first is under FA 2003, Sch 15, para 17A, and this relates to a withdrawal of capital funds from the partnership by the partner who transferred the land to the partnership. This applies to any withdrawal within three years of the transfer.

Withdrawal of income profits is permitted but any other withdrawal of funds, either from capital account, or by reduction of partnership interest or on ceasing to be a partner, will cause SDLT liability to arise. The charge also extends to the repayment in the three year period of a loan made to the partnership by a partner.

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The chargeable amount is the lower of the amount of capital withdrawn and the value of the land at time of transfer to the partnership, but reduced by any amount of that value which was charged to SDLT at that time.

It is important to note that the charge depends on the withdrawal of funds or money’s worth within the three year period, so simply reducing the partnership interest, or ceasing to be a partner (which could be on death), does not in itself cause the liability. On the other hand, any withdrawal of capital by the relevant partner is caught, even if the transfer of the land could not have caused SDLT liability because that same partner was entitled to virtually all the partnership income profits. What an extraordinary rule – see ***Example 4***.

Final hurdle

The second head of charge is under FA 2003, Sch 15 para 17. This gives rise to a charge where a person transfers land to a partnership and subsequently that person transfers part or all of his interest in the partnership ‘pursuant to arrangements which were in place’ when the land was put into the partnership.

Remember that a change of income profit sharing is a transfer of an interest in the partnership. Arrangements includes any agreement or understanding whether legally enforceable or not (Sch 15 para 40).

The charge is related to the market value of the land at the date of the change in partnership interests. There is no exception for cases where a subsequent transfer is to a close family member nor any application of the sum of the lower proportions calculation. This provision has no time limit and is completely open ended. It has seemingly very wide scope so that it could catch transfers of partnership interests many years after the transfer where there was always an intention that one day the incoming partner will take over the business. Of course it is unlikely that this is what para 17 was designed to catch but this is one of the many grey areas of SDLT and partnerships due to poor drafting of the legislation.

If profits are divisible in differing percentages for various levels of fluctuating profits, there can be automatic transfers of partnership shares each year with consequent potential SDLT liabilities.

The important point to take from this is that where land is transferred to a partnership, the sharing of income profits should ideally be in fixed percentages as the partners then intend them to be for the foreseeable future, with no current plans to change them. This does not however prevent a change of partnership income shares which is decided upon in the light of subsequent events.

All in good order?

It would be interesting to know if HMRC believe these rules to be all working well. Clients find them to be beyond understanding.

Example 4

Assume that in ***Example 2*** Mr Berry did wait until Maybelline and Mr Cochran got married before transferring the land into the partnership so the transfer was free of SDLT liability. The transfer was on 1 July 2019.

Two years later a developer unexpectedly offers £2m for some of the land. After longwinded negotiations the sale goes ahead and completes on 31 May 2022. This plot was valued at £1.5m when it was transferred to the partnership.

Mr Berry does not want this cash sitting in the partnership so he withdraws it as soon as soon as it is received to invest in AIM shares and continue some IHT protection.

The withdrawal is within three years of the transfer to the partnership and so SDLT is due on £1.5m, amount due £64,500. Mr Berry protests that both he and the developer paid SDLT when purchasing the land and he was only getting his own money back, nobody else having a share in any of it. But none of that is relevant.

Had he waited until 2 July 2022 before taking the money out, no SDLT would have been payable.

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