Farming as a shelter for CGT

Planning permission for property development – tax planning around the habitats directive and the possible planning gain supplement

The pre-Budget report produced understandable interest in the timing considerations of property development projects.

It is a fact that all development projects will incur delays. From a tax perspective it is generally essential that the asset e.g. land, property and or buildings retain their business status during the period of waiting in order to achieve maximum business asset taper relief (BATR) for Capital Gains Tax.

The rejection of property planning applications for environmental issues have been legendary and obviously from the angle of the protection of wildlife and our habitat totally justified. For example:

- An application for the development of a container port on the Solent was rejected after a four year planning process, in part because of the impact it would have on mudflats used by the dark-bellied brent goose;
- A development of up to 20,000 houses Thames Basin Heaths was blocked as it threatened the habitat of three endangered birds including the Dartford Warbler; and
- Environmental protests led to tunnels being built under the M8 to protect Badgers from the new road and rail link to Edinburgh airport.

So how does the need to obtain planning permission before the tax "punishment" of the planning gain supplement reconcile to environmental delays?

Change in the Process of Rejection for Environmental Issues
Many of the delays and rejections are caused by the "Habitats Directive". Ironically it is good news for development projects with regard to timing. Following a European Court Ruling, Planning Circular 06/05 is being amended to make clear that the Habitats Directive applies to the assessment of development plans. Under the new regulation it is likely (and hopeful) that development projects will be rejected at the development plan stage rather than following a full planning enquiry. The regulation should come into force in 2007 and give greater clarity to timescale.

Reluctant farmer/businessman
The advantages of business asset taper relief (BATR) have been well documented. To qualify for BATR the asset must be used in an individuals own trade. Since 6 April 2002 provided that a business asset has been owned for a minimum of two years and used for a business purpose then the rate of capital gains tax is 10% (40% top rate of tax less 75% business asset taper relief). The serial entrepreneur could possibly take advantage of these business rules by aiming to ensure that land due for development would obtain business status.

The obvious choice of trade to establish business status is farming which includes stud farming - many potential developers have taken advantages of contract farming arrangements or grazing agreements to establish the activity of a trade. With the necessity for alternative land use within the farming world, the business could be a diversified activity although this could involve more complications in trying to achieve business status for BATR.

The benefits of planning application delays
Many of the delays caused by the planning authorities can help the tax efficiency of the project – BATR requires that the asset must be owned for two years AND have full business status for that time, problems of ensuring that the application is compatible with local planning

policy can serve to ensure that all the necessary tax criteria are in place for the project. But where does that leave the impending threat of the planning gain supplement?

The tax problems of the Limited Company

A Limited company is a business vehicle that is not eligible to claim BATR on the disposal of company assets. A company is eligible however to claim indexation allowance. Property with development potential might be removed from say an owner managed company before the planning permission is obtained. This could be fraught with tax difficulties e.g. the tax charge as the asset leaves the company both in terms of corporation tax on the potential gain and distribution to owner manager. Accurate valuations at the point of exit will be critical and it is extremely likely that the district valuer will try to question the quantum. Ironically the apparently tardy behaviour of the planning authorities can help towards achieving the two years of non-corporate ownership for BATR plus help in arguments with the valuation especially when the time delays between approaching the planning consultant and achieving planning consent is potentially decades not years.

The problems of the lengthy planning process

The timing delays can have expensive tax disadvantages to the owners of the business asset used in the business and from 6 April 2004 property let to a trade under s.160 FA 2003 qualifies for BATR. If the frustration and anticipation lead the owner to not use the asset in the trade e.g. farmland left fallow (but not forming part of formal set-aside) or industrial units not let or not used by the business then "tainted taper" could enter the future CGT computation.

"Non-Use" of an asset in a future CGT calculation

The view of HMRC (see para 17958 of the capital gains manual) is that "...no apportionment is required where part of the asset is not being used at all. Where part is being repaired or refurbished, that part is unlikely to be capable of having any use. However, refurbishment by a lessor may amount to use in the leasing activity".

There has been a distinction here between "part of the asset is not being used at all" and the whole of the asset. When large development proceeds are in the pipeline it would be bold for the owner to leave any part of the land that is due to be developed unused. Buildings should be used for storage in the same way farm land should be "contract/share" farmed until the property is sold to the developer. It is considered that it is now HMRC's view that parts of assets that are not used at all are ignored for apportionment under para 9 schedule A1 TCGA 1992.

Property Refurbishment

HMRC consider that if a building is being refurbished by an owner-occupier it will not qualify as a business asset for this period on the basis that it is not 'being used' for the purposes of the trade as it probably can't be used at all.

A building that is not being used at all is a non-business asset and, if subsequently used for the purposes of a trade, will lead to a mixed-use taper relief computation on sale. During a period of refurbishment of a property the owner might again be able to use part of the building for say storage for the trade.

Mixed use – time apportionment

The BATR could be tainted for mixed use. The statutory guidance at para 3 sch A1 TCGA 1992 states BATR is to be given to reduce a chargeable gain arising to an individual, to trustees or to executors on the disposal of a business asset if that asset was a business asset throughout its relevant period of ownership. But what if there has been a lapse? Sub-para (2) then extends the concept to an asset that has not been a business asset throughout the relevant period of ownerships on the basis that the asset has been a business asset throughout one or more periods of its relevant period of ownership, then a part of the gain is to be taken as if it were a gain arising on the disposal of a business asset and the remainder a gain on the disposal of a non-business asset. The apportionment of the gain between business and non-business as explained at sub-para (3) is to be done on the basis of the lengths of the periods during which the asset is taken to have been a business asset.

Mixed use – assets used at the same time for different purposes
Para 9 sch A1 TCGA 1992 states that in 'Cases where an asset is used at the same time for different purposes', a further apportionment is required. This gives guidance on situations where the asset, during a period, is a business asset by reference to the purposes for which it is used, but is also, at the same time, put to a non-qualifying use.

For that period, the 'relevant fraction' of the period is to be treated as a period during which the asset was not a business asset. The relevant fraction is defined as the fraction which represents the proportion of the use of the asset during that period that was a non-qualifying use.

Mixed use – proportion of non-qualifying use is different at different times.
It is further provided that, if the proportion of non-qualifying use is different at different times, a separate relevant fraction has to be used for each period for which there is a different proportion.

According to para 21 sch A1 TCGA 1992, the calculation of the 'proportion of the use of the asset during that period that was a non-qualifying use falls within the general rule for apportionments: on a just and reasonable basis; and on the assumption that an 'amount' falling to be apportioned by reference to any period arose or accrued at the same rate throughout the period over which it falls to be treated as having arisen or accrued. So what is "just and reasonable" – what does the judgement have to be?

HMRC have now agreed that where an asset has been used partly for purposes that qualify as business use under para 5 sch A1 TCGA 1992 and partly for purposes that do not, any apportionment that is needed should be based on area and not on value (or any other basis). This is particularly relevant in the case of farms and estates especially where development or high value gains are involved.

Part disposals out of mixed-use assets – apportionment of gain.
If the details so far appear confusing then reinforcement needs to be sought through the guidance via Capital Gains Tax Manual 17959.

Where there is a part disposal of an asset that has been used partly as a business asset then an apportionment of the chargeable gain needs to be made for any 'mixed-use period'. That apportionment of the gain on the part disposal is necessary to separately apply the business and non-business rates of taper relief. It should be based on the use of the whole of the asset during the relevant period of ownership and not the use to which only the disposed part of the asset was put (if different). The relevant period of ownership will run from the date the asset was acquired (or 6 April 1998, if later) to the date of the part disposal transaction up to a maximum period of ten years.

Following a part disposal when the remainder (or a further part) of the asset is disposed of it will also be necessary to apportion the gain from that later transaction into business and non business elements. That apportionment will again be based on the use of the asset in the relevant period of ownership. That period runs from the date the asset was originally acquired (and not from the date of the intervening part disposal) through to the date of the later transaction. The apportionment of the gain on that later transaction is determined by the respective business or non-business use of the asset, or so much of the asset as was actually held by the owner at any time in the period.

Statement of practice D1 does offer an alternative approach that may be adopted in the case of part disposals where there has been no previous part disposal completed under the statutory formula.

Contract with developer – ensure the paperwork is in place
It has been known for property owners not to show the contract with the developer to their tax adviser on the basis that planning permission has not been obtained yet so why waste money?

In a more extreme case that went to the Court of Appeal there is clear evidence as to why all parties should sign a well reviewed contract, option or promotion agreement. The decision was that the developer was awarded a 50% share in the increase in value of a property due to the grant of planning permission to the developer who invested in obtaining the planning permission. The developer's action, relied on a verbal agreement that the landowner would sell the property to him. Developers should remember though that in order to succeed it was necessary to show unconscionable conduct on the part of the landowner. This element of unconscionable conduct will often be difficult to prove. The contract should define the future "tax point" and the basis for the calculation of the tax due.

Ring fence development land

The "waiting game" might give the tax payer the opportunity to remove the potential development land from the main trading operation to ensure that the mixed used problems of BATR are avoided (no doubt the planning authorities will allow enough time). The downsides are clearly the valuation on exit from the main trade, the possible early payment of some CGT and risk of attack by HMRC for artificial transactions. There is also the need for the future problem of the planning gain supplement to be considered.

Early review of potential tax liability and possible use of Tax Counsel

Clearly the tax problems that surround the CGT calculation dictate an early review and possible CGT "tax audit". It will be essential to be able to use accurate property values and estimates/calculations of proceeds of future development etc. The complexities and potential size of the capital gain and potential downside of a substantial tax liability if the 10% CGT rate is not achieved would point towards the instruction of a tax barrister to help decide the way forward.

The decision will rest with the client, the tax adviser has a duty to ensure that all the tax "pitfalls" have been risk assessed and then the planning application will be successfully opposed for environmental issues such as Grass Hoppers or Dark Bellied Brent Geese or the Dartford Warbler. Perhaps 2007 will be the year when there are rejections at the development plan stage and not after years of debate and abortive tax costs. Hopefully the early decision will assist with considerations as to potential tax liabilities and the future risk of the planning gain supplement.

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