Gravel Money

JULIE BUTLER FCA reviews the taxation of mineral royalties.

THE TRADITIONAL TAXATION of mineral royalties is still half income tax and half capital gains tax. Mineral royalties are not eligible for business asset taper relief, which is significant from 6 April 2002 when full taper relief became available. The review of the taxation of mineral royalties has become even more relevant with the introduction of aggregates levy from 1 April 2002.

One of the most common commercial minerals is gravel, and there are a number of ways of trying to have the extraction taxed as efficiently as possible. Essentially, capturing the monies as capital rather than income will be important.

Inclusive sale of land

If the owner were involved in a number of transactions whereby he sold the land and the gravel, the sale could fall under the speculative transaction rules and be deemed to be an adventure in the nature of trade. The six badges of trade would be:

- the subsequent matter of realisation;
- the length of period of ownership;
- the frequency or the number of similar transactions;
- supplementary work on assets sold;
- reason for sale;
- motive.

Right to buy back

The sale of land including gravel with the right to buy back the land is essentially a disposal for capital gains tax. Provided it has been farmed, it should qualify as a business asset and be eligible for rollover relief, business asset taper relief, and indexation up to 5 April 1998.

The income element is calculated under the normal premium rules, and is assessable as income in the period in which the sale occurs. The term of the lease for the purposes of computing the income element is the period between sale and repurchase. If there is no one particular date, but a series of possibilities arising from the sale contract, the repurchase is treated initially as taking place at the lowest possible price under the terms of the sale. The vendor then has six years from the reconveyance to make a claim, to recover any excess tax paid once the actual date of the reconveyance is known.

A right to buy back documented in writing could be caught under section 36, Taxes Act 1988. This section is a further anti-avoidance provision which seeks to tax the difference between the sale price and the lower purchase consideration as a deemed premium.

Right to lease back

Essentially, a sale with the right to lease back will be caught in part as income and not capital, and is, therefore, not eligible for business asset taper relief.

Where an owner of land (or any other description of property) enters into a transaction whereby he becomes the lessee of that property, e.g. sale and lease back, and there is a subsequent adjustment of rights and liabilities under the lease (whether or not involving the grant of a new lease), which is on the whole favourable to the lesser, such an adjustment is a disposal by the lessee of an interest in the property (section 29(4), Taxation of Chargeable Gains Act 1992).

With sale and lease back, the proportion of capital sum received is taxed as income in certain circumstances. Under section 779, Taxes Act 1988, where the lease when sold has no more than 50 years to run and the period for which the premises are leased back is 15 years or less, a proportion of the capital sum received is to be taxed as income.

It should be noted that there is a let out for leases entered into within 30 days.

Right to further monies

Where land is sold and there are rights to further monies depending on the amount of gravel, the uplift should be a capital disposal for capital gains tax. If the contract includes subsequent payments for uplift in value subject to gravel extraction, the uplift in value could be eligible for business asset taper relief. Provided that this is a genuine disposal and not a trade in gravel, it will be subject to capital gains tax. The wording of the contract will be important.

Retaining some rights

It might be that the land is sold as a capital gain, but the contract for sale has a few worrying clauses, such as the vendor retaining the shooting rights and agreeing to keep the land 'tidy', the purpose being to protect the vendor's other land.

Such conditions, if genuine and correctly drafted in the contract, should not detract from the capital gains tax position and the business asset taper relief.

Royalty to extract gravel

Mineral royalties (including gravel) will be charged to income tax and capital gains tax. Under section 122, Taxes Act 1988, mineral royalties are taxed half income tax and half capital gains tax with no business asset taper relief available.

The advantage is that the land is retained. The disadvantage is that income tax is charged at high rates, and no business asset taper relief is available on the capital gains tax element.

Premium received

If the land including the gravel is leased for a period of under 50 years, as a premium it will be treated as if it were rent and taxed as income in the year of receipt. The gravel extraction company leases the land and pays a premium for this (section 34, Taxes Act 1988). The income element is determined by reducing the premium by two per cent for each year of the lease less one. The resulting figure will be assessable to tax under Schedule A as additional rent.

Treasury route

The treasury route is a well-tried method where the landowner sells a capital tranche of gravel with a licence for the aggregates company to enter the land for purposes of extraction. The aim is to achieve the profit as a capital gain as far as possible achieving business asset taper relief. This takes the sale of gravel in capital tranches one stage further by including the surface of the land so that the capital tranche is a business asset for further business asset taper relief. Should one achieve ownership of the land, disposal of gravel is subject to capital gains tax. The key is to establish a capital gain in-house. For instance, the land could be put into settlement or gifted to a member of the family. It must be pointed out that where the land is being genuinely farmed by the owner and there is no risk of tainted taper from 5 April 1998, there is no need to set up a trust.

Assuming that full taper relief is available, the result should be ten per cent capital gains tax, which is funded out of the first tranche sales to the aggregates company. If the calculation is correct, there should be no further tax. It is a good idea to put a restrictive covenant on the number of cubic metres. The downside is that for the aggregates company, under section 418, Capital Allowances Act 2001, capital allowances are given at only ten per cent a year. However, when the tranche is exhausted, the company is entitled to claim a balancing allowance for the balance of the amount spent (section 428, Capital Allowances Act 2001), *i.e.* the aggregates company will not receive 100 per cent relief until the end of the tranche.

Capital gains

The aim is, by using the treasury arrangement, to have the profit arising from the sale of mineral rights treated as a capital gain, eligible for business asset taper relief, rather than as partly income tax and partly capital gains tax with no business asset taper relief.

The Revenue quotes *Chaloner v Pellipar Investments Ltd* 68 TC 238 (which in turn depends upon *Marren v Ingles* 54 TC 76) as authority for the statement that the grant to a right to a profit (*à prendre*) or a licence is not a part disposal of the land. It then says the profit deriving from the granting of the licence arises from the creation of the licence. This is not an asset used in the farming business, and as such business asset taper relief is not due.

Chaloner v Pellipar was about a landowner who leased two pieces of land in central London to a developer, in consideration of his developing a third site for the benefit of Pellipar. It was about the time that re-basing came in, and the date of the disposal was critical.

Pellipar argued that the gain was taxable under section 22(1)(*d*), Taxation of Chargeable Gains Act 1992, which meant that the date of the disposal was the date that the development was completed (and handed over to Pellipar), rather than the date of the original contract. Section 22 deals with cases where a capital sum is received, but the payer does not necessarily receive a capital asset in exchange. Having said that, the judge made the point that nothing in section 22 excluded situations where there was a capital asset that changed hands.

The judge concerned himself with whether he had authority, from *Marren v Ingles*, for the granting of a lease to fall within section 22(1)(*d*). Although Lord Wilberforce, in *Marren v Ingles*, gave examples of transactions in land that would qualify for taxation under section 22(1)(*d*), these examples were a licence or a profit (*à prendre*, presumably), not a lease. While admitting that it was not authority for his statement, Mr Justice Rattee said that it was consistent to omit reference to a lease. Although he had previously said that there was nothing in section 22 that prevented it from being used to tax a transaction in which no capital asset changed hands, he said:

> 'the words of paragraph (*d*) are apt to include the former, *i.e.* licence/profit, but not the latter, *i.e.* leases. Those words are apt to include capital sums received as consideration for the use or exploitation of assets, title to which remains unaffected in their owner, referred to in the opening words of section 22(1), but are not apt to include capital sums received as consideration for a grant of the owner's title to the assets, whether in perpetuity, or for a term of years.'

It should be borne in mind that the basis of the taxpayer's appeal was that, if the receipt of the consideration could be deemed to fall within section 22(1)(*d*), as a 'capital sum received as consideration for use or exploitation of assets', then it was outside the general provision in section 28 (time of disposal), *i.e.* the date of the contract, because section 28 is subject to section 22 (which gives the time of disposal as the time at which the capital sum is received).

'No madam, neatness and correct spelling don't count.'

The decision of the judge was therefore whether the development value received should be tied to the disposal of the two leases, or whether it could somehow fit within the definition (as consideration for use or exploitation of assets). Since it was undoubtedly additional consideration for the two leases, his decision is not surprising. His comments on licences/profits are very brief. He merely draws a distinction between licences/profits, where the asset title is unaffected in the hands of the owner, as opposed to leases, where there is a fundamental effect on the grantor's rights, which no longer extend to the land. He does not look at the difference between licences and profits, nor did he look at the different type of licences.

In the context of selling the mineral rights to a piece of land, two difficulties arise.

Difficulties

Firstly, is the right to take a substantial amount of minerals from the land really treated in exactly the same way as a mere licence, say, to walk across a field? In the first case, there is a permanent effect on the land that could turn from being useful agricultural land to a water-filled pit. It would be surprising in those circumstances, if it were not treated as a part disposal because part of the value would have gone, once the mineral content had been mined. According to Megarry & Wage's *The Law of Real Property*, there are many types of 'profit' ranging from shooting rights to pasture rights to mineral extraction rights. The latter is called a 'profit in the soil' (paragraph 18-223). It may exist either as 'appurtenant', *i.e.* attaching to a piece of land, or 'in gross', *i.e.* as an independent right granted to an outsider, not the holder of the land.

In the former case, it is capable of 'reservation' (paragraph 18-093), *i.e.* mineral rights can be excluded, or 'reserved' from a sale of that land. This seems to indicate that a disposal of mineral rights *is* capable of being a part disposal, particularly if the grantee is the lessee of the surface, as is the case in the treasury arrangement. There seems to be a legal difference between the situation where a stranger is permitted to enter the land, take some sand and leave (with no restriction to the landlord's rights), and the situation where the lessee of the surface has the right to occupy that surface, build mining works and extract minerals to the exclusion of others, including the landlord.

Most profits fall into the former category (paragraph 18-213 to 18-223) hence, presumably the comments of Mr Justice Rattee in *Chaloner v Pellipar* that, 'The grant by a freeholder … of a ... profit leaves his rights to the land unaffected …'. He was clearly envisaging the first category of profit above. If you start with a field and then, for a period of years have a mining works which is operated for the benefit of the mining company, then no one could say that your rights to enjoyment and use of the land are unaffected. The judge was merely saying that licences and profits could be examples of assets falling within section 22, while leases could not. He did not exhaustively consider all the different types of licences and profits, because he was only concerned with whether the granting of a lease was a part disposal or a capital sum derived from an asset.

The only explicit reference we have at present, differentiating between leases, licences, and profits, puts licences and profits under the same heading, and implies that they are taxable under section 22 (the catch-all for taxing capital sums, even if there is no capital asset acquired by the purchaser).

Inspector's development

Then, to add to the basic legal problems, it is necessary to address the Inspector's development of the judge's comments, to the effect that 'the profit deriving from the granting of the licence (this) would not appear to be an asset used in the farming business …'.

The Inspector covered himself by saying that, whether or not the granting of a licence counts as a part disposal (which it needs to do in order to qualify for business asset taper relief) depends upon the wording of the licence. This implies that, if the licence grants rights to the exclusion of the landlord, then it might qualify as a part disposal. The danger point is that this might make it a lease and, if so, we might have income tax problems under section 36. There could also be drafting problems turning a licence into a lease, although, interestingly, taxationweb (www.taxarticles.co.uk/agricultural_land_property_tax_relief.html) says that 'a licence agreement, however, can give a licensee exclusive possession. In such a case, the agreement may be called a licence but for tax purposes may be deemed to be a tenancy'. Licences in force prior to 1 September 1995, when the Agricultural Tenancies Act 1995 took effect, became exclusive on that date by operation of law (see paragraph 14-020). We should be aiming to have such an agreement which:

- does not fall foul of the income tax rules for leases (note that the definition of lease in section 24(1), Taxes Act 1988 includes any tenancy). The restriction to leases giving right of occupation as against the landlord (section 24(6)) does not apply to sections 34 to 36;
- transfers part of the value out of the land to the extent that it counts as part disposal without falling foul of existing precedents, *i.e.* licences/profits *à prendre* are generally not part disposals.

Reverting to the question of whether the Inspector is correct in saying that the asset from which the capital sum is derived, in the case of a licence, is the licence itself, it is interesting to see in *Tax Bulletin* issue 61, on the subject of capital sums derived from assets, that 'the question will often be whether the sum derives from the asset itself, or from a right to take action for compensation or damages'. In the case of the removal of minerals from land, if a company took minerals without permission, and then paid compensation, Extra-statutory Concession D33 would deem the underlying asset to be the land, in which case business asset taper relief would be available.

If the Inspector is correct, a prior agreement for the company to take the minerals before entering the land renders the capital gain ineligible for business asset taper relief.

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