

Inheritance tax planning – the risks of doing nothing with potential development land

It can be argued that all land and most buildings have a degree of potential development or 'hope' value. There will always be some opportunity to 'grow' more houses, improve buildings and convert barns. The problem to consider is how this value will be protected to ensure that inheritance tax (IHT) relief is achieved on either the potential or the development proceeds.

Risks of the 'do nothing' strategy

If the potential development asset is held within a business, such as farmland within a large working farm, there is the temptation to do nothing for now and worry about it later.

However, when the potential development land is owned by the 'inheritance-tax-vulnerable' – such as an elderly farmer or a landowner with health problems – what action can be taken? Where planning permission has not been obtained for potential development land, there is often no guarantee that the development land or a substantial part of it will be sold during the lifetime of the landowner.

If the estimated time for obtaining planning permission is, say, three to four years in relation to a substantial proportion of the development land, then there is a realistic risk that the landowner would still be alive when the development is realised and the value of his estates for IHT purposes would increase very substantially. This is because the hope value would have been realised. There is always a substantial leap in value, which reflects the change from a probability of planning permission to a certainty. Any cash or binding contract for sale would not qualify for Business Property Relief (BPR). This is because either the surplus cash would be regarded as an excepted asset or the retention of such cash or any investments purchased with the cash would convert the business into a non-qualifying business. There could be a situation where the farming business holds the cash and is therefore deemed to be an investment business because either the cash or the investment in development land is greater than the trading activity.

Reinvesting the development proceeds

Of course, there still would be the prospect of reinvesting the cash proceeds in other farmland or other businesses that qualified 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. However, there would have to be clear documentation of this intention.

There are very considerable practical and commercial obstacles to reinvesting that amount of money from a large development within a relatively short timescale:

- From a commercial perspective, it would be sensible to stay with the businesses that the landowner understood and could manage.
- If the business was limited to farming, it might well not be easy to acquire sufficient quantities of additional land, the right quality in the right location and at a sensible price, for the replacement land to be incorporated effectively into the same business.
- There would be a fundamental question of who was going to manage this greatly expanded farming enterprise and whether the landowner would have the energy to carry out the management.

Therefore, there is the substantial risk that if nothing is done with potential development land, there will be an IHT charge at 40% on the full amount of any realised development value to the extent that that realised development value was not reinvested in qualifying assets. Such an IHT charge will be more onerous than a Capital Gains Tax (CGT) charge.

CGT and IHT battling for importance

The question of 'doing nothing' against gifting during lifetime highlights the downside risk of increasing the 'effective rate' of CGT and weighing this against the upside benefits in terms of reducing IHT as a result of removing the asset from the landowner's estate at a much lower market value. It is assumed that the lifetime gift is at a lower value before the full value is realised.

The advantage of doing nothing is that if a person makes no actual or deemed disposal of an asset during his lifetime, he will incur no CGT liability. His estate will then obtain the benefit of the CGT-free step up in base cost. Therefore, if they choose to sell part of the land, the landowner's personal representatives are more likely to realise a smaller gain and therefore suffer a reduced CGT liability.

Conclusion

With regard to IHT planning, if a farming landowner, or general business landowner is holding potential development land within their business with a view to sheltering potential IHT, there are serious risks of 'doing nothing' as the development project approaches. However, 'doing nothing' is not an alternative that can be assumed without working through the considerations of lifetime giving.

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