Tax Planning and the 'Overage'

Julie Butler on the importance of protecting the development profit

With the current continuing demand (and need) for housing, combined with relatively high property values, the necessity for all property owners to try to achieve a 'slice of the action' in any future development profit ('overage') has never been stronger.

What is 'overage'? 'Overage' is securing the rights to future value. 'Overage' is the vendor making a statement in the sale agreement as follows: 'You may realise additional value and if you do, you will pay me for it.'

At first glance, 'overage' might appear just to apply to farmland that might be developed at a future point. It can however include a much wider range of property – for example, private dwellings with large gardens or low-key business and residential property that might at some stage enjoy development value.

Types of 'overage' 'Overage' can take the form of a restrictive covenant, a reverse option, a lease with an option to purchase the freehold or a 'ransom strip'. The key is to put a structure in place to ensure a tax-efficient overage payment.

Protecting the right to future development profit

Every person involved in property disposals must consider the need for clauses which protect the vendor's right to a share in the future development profits. There have been cases where solicitors, land agents and estate agents have been sued for negligence for not bringing the opportunity for 'overage' to the vendor's attention.

It is therefore important that all land and property sales not only include the protection of a right to future profits but also recognise the need to ensure that, when the monies are received, they are taxed efficiently. Firstly, the key is to capture the 'profit' as a capital asset subject to capital gains tax, with all the potential tax advantages (for example, the annual exemption, principal private residence relief, indexation, business asset – and non-business asset – taper relief and rollover relief).

The potential income tax trap The potential income tax trap is that of section 776, *Income and Corporation Taxes Act 1988*. This assesses gains on the sales of land to income tax, not capital gains tax. Section 776 applies where:

> Land is developed with the sole or main object of realising a gain from the sale of that land when developed;
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> Land, or any property deriving its value from land, is acquired with the sole or main object of realising a gain from disposing of that land; *or*
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> Land is held as trading stock.

Charities Charities can suffer under section 776. There is no exemption for charities and so it is essential to ensure that 'overage' is structured as a capital payment.

An alternative is to use an incorporated trading subsidiary which is a UK limited company. The key is then to make Gift Aid payments of the company's profits to the charity to ensure that no liability to tax arises.

Non-UK residents Non-UK residents are not chargeable to capital gains tax; however they are chargeable to income tax on income from UK property. Non-UK residents will therefore be subject to section 776 on their sales of UK land chargeable to income tax under that section.

Companies Companies do not enjoy business asset taper relief (BATR) so it is not so important for the 'overage' to be taxed under the 'capital' structure as opposed to an income structure.

Restrictive covenants

A restrictive covenant is property. It derives its value from the land and therefore a payment for release from a covenant should be assessable to capital gains tax.

On disposal the vendor receives consideration, which is the purchase price. The restrictive covenant is not a business asset and therefore not eligible for BATR, but it will achieve non-business asset taper relief. Clearly, this is an improved tax position on the top rate of income tax.

'Slice of the action' contracts

In 'slice of the action' cases the vendor is to receive an agreed percentage of the future development profits. The initial consideration is for the disposal of capital assets and may therefore be subject to capital gains tax. 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. It will be caught under section 776 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. It will therefore be taxed as income.

Early tax planning is essential

Clearly it is important to maximise receipts in the hands of the vendor and this includes minimising the tax liability. It is essential that the tax planning is put in place before the contract is agreed – perhaps this could be done when the heads of agreement are drafted, as the tax position should be checked at this stage.

The key is not only to secure the share of future profits but to secure that right tax-efficiently.

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