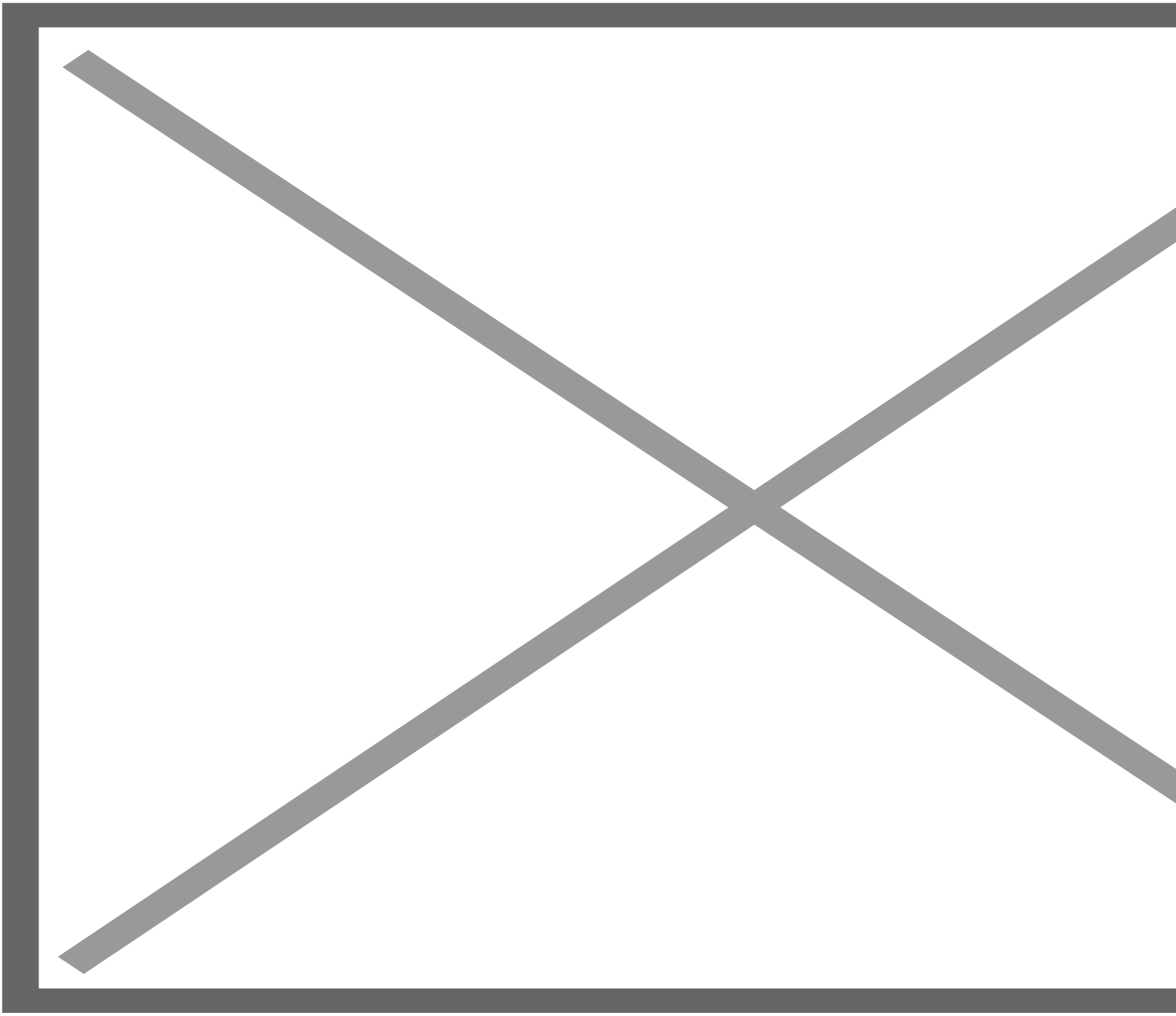
Broad brush approach

Personal tax



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Sharlene Botterill examines the impact of the anti-avoidance legislation in ITA 2007 s 756 in residential property transactions

Key Points

What is the issue?

The scope of the anti-avoidance legislation in ITA 2007 s 756 is broad and could apply to many transactions that were not intended to be artificial. A taxpayer may be confident that a gain will be charged to CGT, and then find himself suffering a significantly higher tax bill.

What does it mean for me?

A property owner needs to be aware of the potential tax due on a disposal. A simple capital gain will be taxed at 18% or 28% whereas, if s 756 applies, the rate could be 40% or 45%.

What can I take away?

Tax planning in advance of a transaction is key. A taxpayer should be warned of the risks and likelihood of s 756 being applied.

A growing volume of anti-avoidance legislation is in place, with the aim of stopping taxpayers from manipulating transactions to avoid taxation. The scope of anti-avoidance does not only include situations where tax is completely avoided – it also targets transactions where income or gains are seen as having been shifted to a lower rate of tax.

An example of this is the anti-avoidance legislation 'Transactions in land' in ITA 2007 s 756 which was introduced to deter land transactions being artificially manipulated to avoid taxation. These rules target gains of a capital nature from the disposal of land wholly or partly situated in the UK.

Although the difference between capital and income tax rates is not as significant now as it has been, there remains a substantial tax advantage of a gain being classified as capital rather than as income.

If a transaction is caught by the rules, the gain is treated as income for the individual in the year of disposal, rather than as a capital gain. As a result, the gain could be subject to income tax at a rate of 40% or 45% (ignoring marginal tax rates) as opposed to the maximum capital gains tax rate of 28%. The gain is not, however, liable to national insurance contributions (NICs).

The conditions for s 756 to apply

A transaction will fall under the provisions of this legislation when the land (or any property deriving value from it) either:

- is held as trading stock; or
- is acquired with the main or sole purpose of realising a gain on its later disposal; or
- is developed with the main or sole purpose of realising a gain on its later disposal.

If it can be argued that the transaction falls under the so-called badges of trade, any profit will already fall, in priority, within charge to income tax (and Class 4 NICs). Since there has been no avoidance of income tax, the s 756 rules do not apply.

The other conditions are more objective because an intention cannot often be proven in a physical manner. Particular actions, such as obtaining planning permission, are obvious triggers of an intention arising to develop property or land. But in some situations it might be difficult to argue that the individual's primary intention was to make a profit on disposal.

Exceptions

Some transactions are specifically exempt from these rules under legislation.

- The disposal of an individual's main residence. If a disposal qualifies for private principle residence relief, no gain remains chargeable. A chargeable gain must exist for s 756 to be applied.
- If a gain arises on the disposal of shares in a company that holds land as trading stock, as long as the company sells the land as part of its normal trade.
- If land is developed with the intention of realising a profit, an apportioned amount of the gain relating to the period before the intention arose to develop the land is exempt. The date on which the intention changed is important, but is not always clearly defined – it is simply a question of fact. Usually the date of development physically starting will be acceptable. Gains until then will be charged to CGT, and those after charged to income tax under the s 756 rules.

Application for clearance

The seller of the land can apply in writing to HMRC for clearance that the disposal does not fall within scope of the anti-avoidance legislation. The application can be made either before or after the transaction.

However, an application can be made only for clearance of the 'motive' test – where the individual has grounds to believe that they did not acquire and/or develop the land with the main purpose of realising a gain from its disposal. There is no such clearance for land held as trading stock.

An application involves providing HMRC with all particulars of the proposed or completed transaction. The department must reply with its decision within 30 days. Since that decision is final, the taxpayer has no right of appeal should clearance be refused.

It is vital that an application includes a full and accurate disclosure of the material facts of sale. If HMRC grants clearance under s 756 it cannot be revoked unless the applicant can argue that the original disclosure was in fact not full and accurate.

It is for this reason, perhaps, that clearance applications are not common in practice. Disclosure simply highlights a transaction to HMRC which can easily 'play safe' if there are any doubts in the knowledge that an enquiry could be opened into the tax return after submission.

Calculation of the gain

The gain will be calculated under the capital gains tax rules, taking into consideration the proceeds and any capital expenditure such as legal or surveyor costs and those for refurbishment.

Let's say an individual acquired a property as his main residence but later let it out for several years before deciding to convert the building into a group of self-contained apartments that are sold for a significant profit.

The gain must be apportioned between the periods relating to when the property was his main residence (exempt under PPR), that when it was let out (partly, or possible even wholly, exempt under lettings relief) and, finally, the period after the development work started. This final period would be caught by the s 756 rules, with it falling under the third condition. In this case, the property would need to be valued at the time of starting development to calculate the gain resulting from the works on a just and reasonable basis. This gain will be taxed on the individual as income in the year of the disposal of the apartments.

Use in practice

The legislation is written in broad terms, so there are many scenarios that could accidentally fall under these rules without the seller ever having had any intention of tax avoidance.

HMRC has, however, specified that the legislation is not intended to catch straightforward transactions involving a purchase and subsequent sale of land falling outside the trading provisions.

‘Slice of the action’ schemes

A common situation noted for triggering these rules, is in ‘slice of the action’ contracts. These occur when a landowner sells a plot of land to a developer for a fixed sum, plus future payments that are usually contingent on the future success or performance of the land development project.

Since the purchasing developer will be trading, the future payments will be the transfer of trading profits to the seller. These receipts will be capital in nature for the seller; as a result, such a transaction is considered avoidance of income tax.

Whether there is intention of avoidance has no bearing on the application of these rules; the transaction is caught under s 756 since they are trading profits artificially received in capital form. The original fixed sum will, however, remain a capital gain.