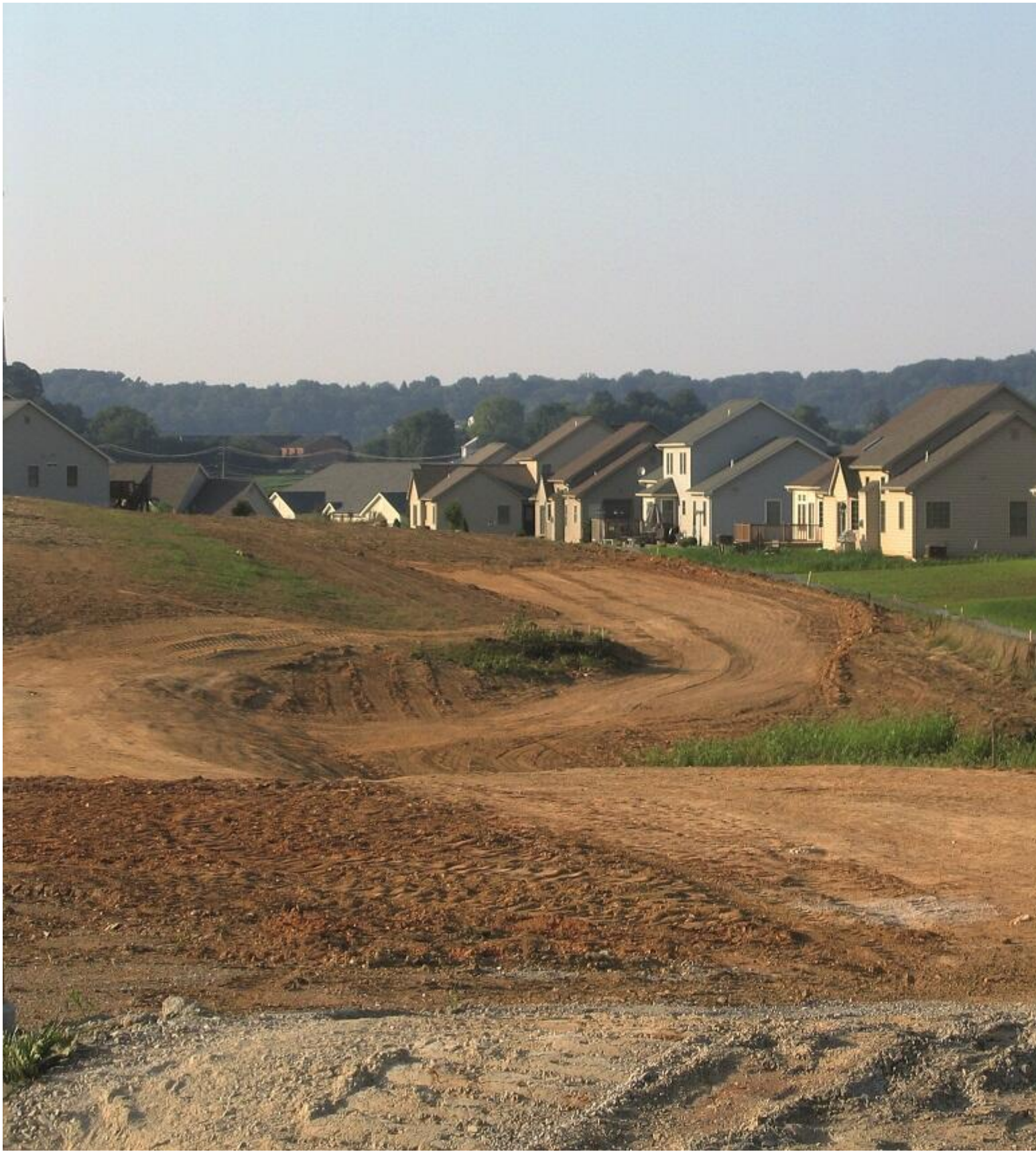
Land in hand

Inheritance tax and trusts



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Julie Butler explains why tax planning for development land should be reviewed urgently

Key Points

What is the issue?

The demand for housing in the UK is high so substantial development profits can be made by landowners and developers. Accordingly, the risk for errors comes with a potentially large tax bill

What does it mean for me?

Emphasis of the need to appreciate that there are tax risks and pitfalls with development land which must be avoided with a protectionary tax strategy

What can I take away?

Review all potential development land opportunities now to ensure that the maximum tax reliefs are achievable. Ensure that all documents surrounding the land, such as tax returns and accounts, protect the tax planning position

The UK has a pressing need for housing to cope with current and future demand. For most land development projects a well-planned 10% rate of capital gains tax (CGT) or rollover relief are the goals. However, the achievement of these reliefs, together with full inheritance tax protection, can be a complicated intereaction. The Budget in March 2015 had much to say about entrepreneurs' relief (ER), and focused on how it is applied to shares in limited companies. When legislation changes there are always unforeseen circumstances and our suggestion is that ER planning and IHT planning for development land should be reviewed urgently.

Inheritance tax (IHT)

It is important to consider the tax implications of the landowner predeceasing the completion of the development – many landowning farmers are in their 70s, 80s and 90s. Care must therefore be taken with IHT protection.

The district valuer will assess the land on death at market value (IHTA 1984 s 160). The 'hope value' (market value less agricultural value) will need the protection of business property relief (BPR). The eligibility of the farmland, together with land used in general business for BPR within the current legal structure must be considered. If the land is used (but not owned) by a partnership, of which the owner is a member, only 50% BPR will be available.

These arrangements should not result in the land being subject to a 'binding contract' for sale so as to cause the loss of APR and BPR, until the developer is ready to proceed and pay for the land. This is something both the draughtsman and the advisers will have to bear in mind. Any redundant land will not achieve IHT reliefs and the decision to bring the land into a trading operation should be considered.

The fundamental rules of BPR are that land must be used in a trade with the 'badges of trade' clearly evidenced for two years before death. For income tax purposes, farming is defined as a trade and the land must be occupied for husbandry. Where there are different persons carrying out different functions on the land, it may be necessary to establish which person is the 'occupier', with the implication that the other parties are not 'occupiers' and therefore are not farmers in the eyes of the tax system. The trade must be carried on for a profit (a gain – IHTA

1984 s 103(3)).

These types of potential land development will not qualify for BPR:

- redundant land;
- land that is let and not used in a trade;
- land with insufficient trading activity; and
- land that is used in an uncommercial trade.

The recent case of *Blaney* (*E Blaney* (TC4103)) emphasises that the land must not be held just ‘for pleasure’ in order to achieve CGT reliefs. In this case it was business asset taper relief (BATR) as opposed to ER.

Examples of areas vulnerable to attack by HMRC on the grounds of insufficient trading activity are:

- ‘fake’ trades put in place just to achieve tax reliefs;
- DIY liveries without service;
- weak contract farming arrangements (CFA) without real involvement by the landowner; and
- weak grazing agreements.

Entrepreneurs’ relief (ER) and rollover relief

The importance of trade

There must also be a trade to achieve ER and rollover for capital gains tax (CGT). Therefore, whether the development project takes place before or after death, there has to be a trade and activity by the owner of the land. If the land is held by the partnership for IHT protection at 100% how does this affect the CGT reliefs that are needed?

The common goal is to pass the ‘trade’ test for all reliefs. There are two uncertainties that have to be worked with for tax planning purposes:

- potential date of death; and
- potential date of development.

The action point is to try to rectify the potential failure of land to qualify for relief, for example by creating a trade on the redundant land, increasing the services, and ensuring the trade is more robust and commercial. To obtain BPR, the previous two years are looked at – so it is essential to act immediately to improve the trading activity.

The grazing agreement and French

French v HMRC [2014] UK FTT 940 highlighted an analytical review of grazing agreements. It can be argued that, with development values being so high, all potential development land should move from grazing agreements to pure ‘farming in hand’ or other trading activity. The case law used by the tribunals is well established. For grazing land the critical criterion for the landowner is that between the grazier whereby the landowner may still be regarded as farming the land. The issues are explained in the cases of *Forsyth Grant* and *Mitchell*.

The tribunal in *French* highlighted in para 32 of the judgment that HMRC's arguments were based on the guidance in their own manuals; this is a weak way to approach a tribunal of this strength. This guidance is found in paras 55060 and 55065 of the *Business Income Manual* (BIM). The tribunal highlighted that the case law shows that the nature of the agreement and the rights given to the 'grazier' by the landowner (or, as the tribunal puts it, 'what the licensee or user is to do with the land') are key. Perhaps para BIM 55065 can be considered as misleading?

The *French* case provides a timely reminder that case law interpretation is the ultimate argument; BIMS are just a secondary viewpoint.

'BIM55060 – Farming in tax law: farm land let for period of 365 days or more s 268 Income Tax (Trading and Other Income) Act 2005, s 205 Corporation Tax Act 2009.

'Where farmland is let for a period of 365 days or more, the tenant will normally be the occupier and hence the person farming that land for tax purposes. The landlord is chargeable on the rents as property income. Even where he or she is at the same time farming on other land, the rents should be charged separately in this way (see *Bennion v Roper* [1970] 46 (TC613)).'

The warnings of McCall

While the vast amount of case law helps give guidance on how to use a grazing agreement to establish a trade, it is a risky 'trading vehicle' for the owner of development land to choose. The potential to return the land back 'in hand' farming has to be considered. There is an explanation that sets out what the unsuccessful taxpayers had failed to do to establish a trade to protect the tax reliefs on development land. This was made by Girvan LJ in the IHT case of *McCall and another v HMRC* [2009] NICA 12 at para 19 of the judgment in the Court of Appeal of Northern Ireland. In essence, if the landowner is to show that he, rather than the grazier, is the farmer, it is key to show the landowner as the farmer on the land.

Entrepreneurs' relief withdrawal

If the trade or the farm is operated as a partnership, but the land is owned by one or more partners personally (although this is not normally advisable for IHT purposes due to the restriction to 50% BPR) and ER is the more immediate goal, it may be helpful to set up the correct structure in advance. The planning is to structure the sale of the land as an 'associated disposal' where there has been a 'material disposal' of a business. For a partner, a material disposal is relatively easy to achieve because a reduction in the partner's interest in a partnership share will be recognised as a disposal of part of the business by the partner concerned. Previously, HMRC offered no guidance as to what classifies as a material disposal; however, the example in CG63995 is a 40% reduction. FA 2015 has now laid down that there must be a reduction in partnership share of at least 5%. There are also new rules related to the entitlements of connected parties.

This opens the way for the partner to dispose of the land as an 'associated disposal' qualifying for ER and only having to withdraw from the business and not cease the business as with the disposal of partnership property. The disposal must be made 'as part of the withdrawal of the individual from participation in the business carried on by the partnership', but HMRC accept that this refers to equity participation and not time spent.

Accordingly, the partner can continue to be a full-time working partner. As long as there is a 5% reduction in equity interest, there is a partial withdrawal from the partnership. This raises the tax planning consideration of the best interaction of the need for partnership property for IHT purposes and efficient use of the associated

disposals rule for CGT. With the possible lack of farming partnership agreements there is a chance that the exact ownership of
land is not known.

Reconciling ER (associated disposal) and IHT

The withdrawal advantage has been shown but what of the IHT protection mentioned earlier? How is the elderly widow or widower with no protection of surviving spouse provided for if they die with an ‘associated disposal’ and only have 50% BPR? On the assumption that development takes place before death the idea is to transfer the trade into a limited company just before the sale of potential development land. BPR is preserved and the cessation required for partnership property is also achieved.

The trade of the farm in the partnership has ceased with the transfer to the limited company. The land is held outside the trading vehicle, the limited company. It is essential not to transfer the land and property into the limited company because there can be problems relating to ATED and benefits in kind (BIK).

Tailor-made tax planning

All development projects are different, as are all family farms, ownership, succession plans and so on. If the recent high-profile dispute cases of Ham v Ham and *Davies v Davies* (‘cowshed Cinderella’) have taught the farming community anything, it is to ensure that strong, well-understood legal agreements are in place for the trading activity. Of development land, there must be a full fact-find to identify the following:

- ownership of land has been fully researched;
- full trading activity is in operation over the appropriate period of time;
- all legal agreements have been reviewed;
- accounts and tax return disclosure reconcile to all legal agreements and tax planning; and
- succession plans have been considered.

The actual proposed sales arrangement and documents should be carefully reviewed because any ‘slice of the action’ schemes, such as share of increased income and receipt of houses, can bring the whole transaction into a trading transaction subject to income tax (*Page v Lowther and another* [1983] STC 799).

The importance of accounts and tax returns

The accounts and tax returns must reconcile to the tax planning. This sounds basic, but the tax planning can fail on these. For example:

- freehold property shown as partnership property when it is not; and
- grazing agreements shown on the land and property pages of the tax return as opposed to being disclosed as a trading operation.

Practical tip

Act now – there is a lot of potential development land to be considered by tax advisers. Many landowners have different goals and aspirations for very valuable development projects, and there are very large tax liabilities at risk. If the tax reliefs are to be achieved, enough legal agreements should be updated, ensuring badges of trade are in place and research carried out into the history of trading arrangements on the potential development land.