Summer 2014

Property Focus

Laying the foundations to future prosperity

Contents:

HAZLEWOODS

DRIVING LIFELONG PROSPERITY

To Pool or not to Pool, that is the question

With the continuing new house shortage and new "garden cities", such as Ebbsfleet, being announced, it is perhaps unsurprising that we are seeing some large scale developments obtaining planning permission. More often than not, due to the acreage of such developments, it is not just a single landowner involved, but numerous landowners "pooling" their land in an attempt to get the best value possible for their collective interests.

The idea behind the pooling arrangement is that no single landowner suffers for the fact that their particular land may be designated as park space, rather than residential, by splitting the proceeds amongst themselves based on their pro rata acreage within the scheme. Another benefit of pooling is that where the land is taken in tranches, the owner whose land is taken last still receives a proportion of the proceeds for the land taken initially.

Of course, this all sounds great until you start to consider the tax implications of failing to get the documentation right.

Often the mechanism for splitting the proceeds is contained within an "equalisation agreement", which just confirms that, regardless of what land is taken for development, each landowner receives their respective proportion. The problem with such an agreement is that it can create a nasty double tax position, because of the decision in Burca v Parkinson.

Take the example of John, Fred and Susan. They each hold 100 acres of land and have entered into an equalisation agreement to split any proceeds equally. Planning permission is obtained and John's land is taken first, resulting in proceeds for distribution of £30m. Based on the equalisation agreement, John transfers £10m each to Fred and Susan.

Logically you would expect each of them to be taxed on £10m. However, due to the decision in Burca v Parkinson this is not the case. John's land is the only land to be sold at that point, whilst Fred and Susan have no legal right over it. As a result, John is unable to obtain a deduction for the £20m he pays to Fred and Susan, leaving him to pick up a capital gains tax liability on the full £30m.

It doesn't stop there, as Fred and Susan are deemed to have received taxable consideration for a different type of asset, known as a "Chose in Action", which results in each of them being subject to capital gains tax on £10m. Therefore, there is a double tax assessment on £20m.

It seems incredibly inequitable for there to be a double tax assessment, but that is the current position, unless steps are taken to stop it arising. So, what can be done?

There are a number of structures that can be put in place to ensure tax is only paid once, including:

- Pooling Trust
- Cross Options
- Restrictive Covenants
- Special Purpose Vehicle

A Pooling Trust is a bare trust arrangement. All land is transferred to the trust and, instead of holding a particular parcel, each landowner holds their respective percentage of the whole developable land. So, in the example above, John, Fred and Susan will each own one third of the whole land, rather than their individual parcels. As a result, each time a tranche is sold, they are each entitled to one third of the proceeds.

With Cross Options, each landowner grants an Option to the others, with the exercise price being its current, agricultural value. Once planning permission is obtained, that Option becomes valuable and, therefore, the payment to the Option holder, for them to cancel their rights, is a deductible payment in arriving at the taxable gain.

It is a similar situation with Restrictive Covenants, whereby the landowner places a restriction on their land, such as the inability to sell or develop without the others' approval. The payment to lift that restriction would also be deductible in arriving at the landowner's taxable gain.

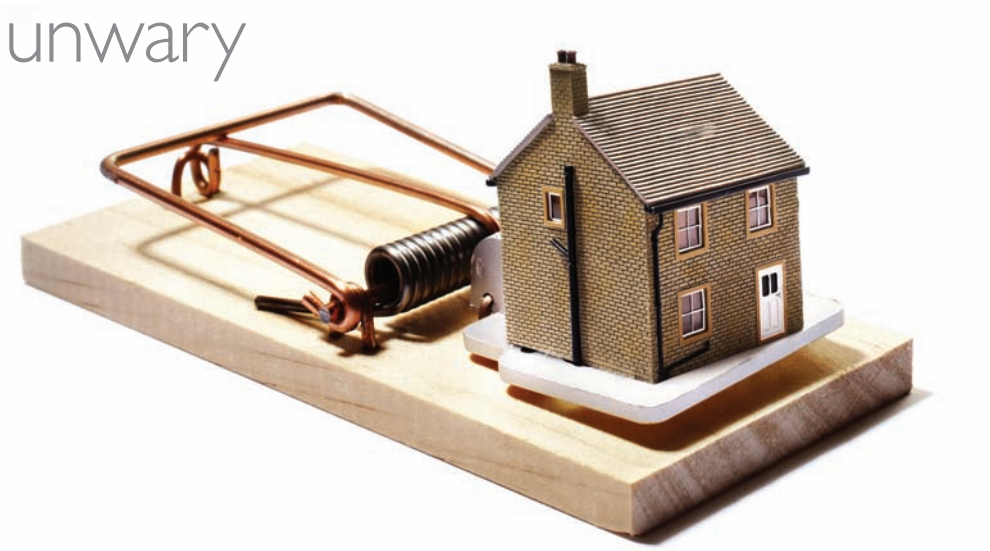
Finally, a Special Purpose Vehicle is just another entity to pool the interests, such as using a company as a "middle man" between the landowners and the developer.

Each of them have their own benefits and drawbacks, particularly in respect of the ability to claim Entrepreneurs' and Rollover relief, if the landowners qualify, so care needs to be taken in deciding which route to adopt.

Other documents that need to be carefully considered are the Landowners' Collaboration Agreement and the Promotion Agreement (if using a Promoter). Both could contain wording that could result in the landowners being held to be in a development partnership, therefore resulting in income tax, rather than capital gains tax. Any infrastructure work to be carried out by the landowners also needs careful consideration.

With land values as they are, getting the structure wrong can result in some significant excess tax to pay, so it is incredibly important to obtain the right professional advice.

Buying Residential Properties
A trap for the unwary



In the last edition of our Property Newsletter we briefly looked at the legislation introduced with effect from April 2013, where residential property is owned through a company or partnership with company members. At the time we thought this would only have limited relevance to property developers and property investment businesses, because it only applied if the residential property had a value of more than £2m. This new tax, which is called Annual Tax on Enveloped Dwellings (generally shortened to ATED), imposed an annual charge of between £15,000 and £140,000 depending on the value of the property. The March 2014 Budget, however, has extended the charge so that ATED will, from April 2015, impose a charge on all residential properties with a value in excess of £1m and from April 2016 it will relate to all properties valued at over £500,000. This will undoubtedly capture many more properties. The new tax bands will mean that on a property valued at over £1m and up to £2m, the annual charge will be £7,000. For properties in the band £500,000 to £1m, the annual charge will be £3,500.

The lowering of the limits will bring many more companies within the ATED regime. Thankfully the charge will not apply if the company is involved in:-

- a property rental business, and the property is held for the purposes of the income it will generate; or
- property development and the property is to be used as part of that activity.

However, the relief has to be claimed on a separate ATED tax return which needs to be made. If a return is not made penalties can be imposed. Because of the lowering of the value at which the charge will arise, many more companies are likely to fall into the trap of not making a return and incurring a penalty, even if no tax is due.

The Budget announcement did go on to say that the administration of ATED will need to be simplified, and there will be consultation on how this could be achieved. It is hoped that this will include the removal of the need for a return if no tax is due, but in our experience with other HMRC returns, this is unlikely to happen.

Capital Allowances

There have been some recent changes in tax legislation as regards the claiming of capital allowances on fixtures, and companies that own properties need to be aware of how these changes could impact on the future disposal value of the properties. These changes also impact on companies acquiring second-hand buildings.

On the disposal of a property, a Commercial Property Standard Enquiries form (CPSE 1) will need to be completed as part of the legal process. One of the purposes of this form is to ensure that the full capital allowances history is obtained prior to the sale and purchase agreement being signed.

What are capital allowances?

Capital allowances provide tax relief to the purchaser of a property and can be claimed on both plant and machinery and certain types of fixtures. In addition, they can be claimed on integral features which include electrical and lighting systems, cold water systems, ventilation systems, lifts and escalators.

For capital allowances purposes, 'fixtures' means 'plant or machinery that is so installed or otherwise fixed in or to a building or other description of land as to become, in law, part of that building or other land', which is not the same as the legal definition.

What has changed?

The policy behind the new rules is to ensure that expenditure on fixtures is only written off once against taxable profits over its economic life. Therefore, when a commercial property is now sold, the purchaser's position regarding what capital allowances are available needs detailed consideration at the time of the transaction, as the availability will be dependent on what (if any) allowances have previously been claimed by the immediate, and also previous, owners.

From April 2012, a 'fixed value requirement' was introduced. Therefore, a purchaser is only able to claim capital allowances on fixtures within the property if he and the seller have signed a

joint election to agree a value for such fixtures on which the seller has previously made a claim. This is documented through a Section 198 election (freehold) or Section 199 election (leases) within two years of the completion date. Although there is a two year window, to ensure this requirement is not missed, it would be wise for the election to be signed at the time of the transaction. There is no requirement that the disposal value to be used must be market value, but it cannot exceed the original cost.

Alternatively, an independent determination can be obtained from a tax tribunal if the two parties are unable to arrive at an agreed value. Again, this application to the tribunal must be within two years of the sale.

Failure to do one of the above - either make a joint election or an application to a tax tribunal - not only impacts on the immediate purchaser but also any subsequent purchasers, as the inability to claim capital allowances will, of course, reduce the value of a property.

It is also worth noting that if the owner has never claimed allowances on fixtures, and makes a statement to that effect, the purchaser can still make a capital allowances claim on the acquired fixtures.

From April 2014, 'the pooling requirement' was introduced. Therefore, in addition to the fixed value requirement, 'mandatory pooling' will be required which means a buyer will only be permitted to claim capital allowances if the seller has 'pooled' all qualifying expenditure that they can claim capital allowances on.

To sum up the impact of the new rules, if the seller has, or could have, claimed capital allowances on fixtures, the purchaser will need to confirm that the seller has allocated the expenditure to a pool and then agree a disposal value for the expenditure by way of a Section 198/199 election or by application to the tax tribunal. If these steps are not undertaken, the purchaser is prevented from claiming capital allowances. It is therefore important that necessary procedures are undertaken prior to signing, otherwise capital allowances will be lost forever on the fixtures acquired as part of the building.

Consequently, all companies that own properties need to ensure that all available capital allowances are claimed. If in any doubt as to whether full capital allowances have been claimed, they should contact their professional tax adviser.

Reducing the Inheritance Tax Cost

For some property businesses Inheritance Tax (IHT) planning is relatively straightforward from a tax viewpoint. This is the case in relation to property development companies because they will generally be classified as trading businesses, and so the value of the business, or shares in the company carrying on the business, will qualify for Business Property Relief (BPR). BPR will generally mean that the value of such businesses, or shares in a company carrying on the business, will be reduced by 100%, and so no IHT is due.

IHT planning becomes much more difficult if the property business is an investment activity, i.e. a portfolio of properties is let to third parties, because such an activity does not qualify for BPR. In these circumstances what strategies can be used? A few ideas are as follows:-

1. If the properties are owned by, say, an individual, they could consider selling them to a company. This would create a Capital Gains Tax (CGT) charge if there has been any increase in the properties' values since acquisition, but this may be considered to be a worthwhile cost if it is not too high. Initially the amount due for the properties could be left on the loan account. At that point the value of the shares in the company would be low, and so they could be given away to, say, the next generation without any IHT or CGT implications. The debt owing for the properties will be part of the individual's Estate, but this can be reduced from the company profits and used as 'income'. This may also save tax on the income arising if the company only pays 20% corporation tax on the profits, compared with the individual having an income tax charge of, say, 40%. The repayment of the loan will not give rise to a tax charge.

   As the loan is reduced and the properties' values increase, the company's value increases. This increase accrues for the benefit of the shareholders, i.e. the next generation, and so is outside of the individual's Estate for IHT purposes. The reduction of the loan also reduces the IHT exposure of the individual.

   With this strategy it is also necessary to consider whether there is any Stamp Duty Land Tax (SDLT) cost.

2. If the investment properties are owned through a company, then the value of the shareholding will be part of the individual's Estate. In these circumstances one strategy could be to give away shares up to the value of the Nil Rate Band (NRB) for IHT purposes, of £325,000, to a Trust for the benefit of the next generation when they are over 18. Giving the shares away directly to the next generation would give rise to a CGT charge, assuming the shares have increased in value since acquisition. However, giving the shares to a Trust means a Holdover Election can be made for CGT purposes, thus deferring the CGT liability.

   If the value of the shares gifted into the Trust is less than the NRB, and provided there have been no other gifts potentially chargeable to IHT in the previous seven years, then there will be no IHT on the gift into the Trust.

   Before the first ten year anniversary of setting up the Trust, the shares could be transferred out to the intended beneficiaries with no CGT (because another Holdover Election can be made) and no IHT charge (provided there was not an IHT charge when the Trust was set up).

   This strategy only produces an IHT saving if the

donor lives seven years after the gift.

If a spouse also owns shares in the property company, then they can also use this strategy.

3. An alternative to '2' above is to issue some new shares which carry rights to all the future growth in the value of the company, whereas the existing shares take all the current value. The new shares can be given away to the next generation, and so they take all the future growth in the property values. This means that the value of the current shareholder's Estate is frozen at today's value, hence the IHT does not worsen by any future property value growth. This could be a useful strategy if there is the potential for some of the property in the company to grow rapidly.

The above ideas can only be described in brief detail in the space available, and so any plans to implement these, or other ideas, should be discussed in full.

VAT and Land Promotion Agreements

VAT, particularly in the property sector, seems to abound with three word phrases designed to cause trepidation to even the most courageous. "Capital goods scheme", "option to tax", "relevant residential purpose", "designed as a dwelling" (ok – so I can't count) are all guaranteed to reduce those involved in land and property development into nervous wrecks!

Now there is another trio of words to cope with – "land promotion agreement". This involves a parcel of land (where often a number of different ownerships are involved) being promoted for development by a promoter, who will endeavour to achieve the necessary planning consents. The promoter may never have an interest in the land themselves (although see further comments below) but nevertheless will receive a percentage of the sale proceeds, once the land is sold to a developer, as the reward for their promotion efforts.

Under the agreement, the promoter will be supplying services to the landowner(s), so that the fee they receive is the consideration for a supply of VAT standard rated services, and will therefore be subject to VAT at 20%.

If the landowners sell their land on a VAT-exempt basis (which is the default position) then the VAT charged by the promoter would be likely to be irrecoverable and would represent a significant extra cost. However, the landowners can avoid this situation by opting to tax their own parcel of land and registering for VAT (if not already registered). When the land is sold to the developer, the landowner would charge VAT at the standard rate. However, it would be anticipated that the developer will be able to recover this VAT, on the basis of the ultimate intention to make either standard-rated supplies of new commercial property, or zero-rated sales of new residential property.

The landowners will need to bear in mind that the VAT registration will impact upon all business activities that are undertaken by the same "entity" that holds the land. Also the addition of VAT to the price will increase the SDLT amount payable by the developer, but this is likely to be a relatively minor consideration in the overall picture.

Although the above describes the basic position, the actual circumstances are likely to be further complicated by the existence of Cross Options between the various owners (to ensure that each receive a proportionate benefit if only part of the entire land area is sold), and in some agreements, the promoter will pay an initial fee to the landowners for being granted the exclusive right to promote the land. All of these result in supplies being made by the landowners, the VAT treatment of which needs to be carefully considered.

There are other structures that may be established to effect the promotion arrangements. In one alternative scenario, the promoter of the land may also be a potential developer of that land. It is likely that the promoter will hold an option to purchase the land and will need to consider whether to exercise that option, or to obtain payment from another developer to assign/forego the option, once the planning permission has been obtained. If choosing the latter course, the promoter (rather than the landowners in this case) would need to opt to tax their interest in the land in order to justify the recovery of the VAT that they have incurred on the costs of the promotion process.

All of this emphasises the importance of all parties taking VAT advice at an early stage of the land promotion process, in order to mitigate the possibility of an "unanticipated VAT cost"- now there's another "three worder" that is best avoided!

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- Transactions, planning and support
- Benchmarking and profitability advice
- Incorporation

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