Hewitsons LLP

Whitepaper

What to do when the developer calls

A legal guide for farmers and other rural landowners

November 2018

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Background

Whichever figures you look at, there is consensus that not enough new homes are being built in the UK. Estimates vary, but somewhere between 210,000 and 300,000 new homes are required each year from 2014 to 2039 to keep up with demand. According to the House of Commons briefing paper *Tackling the under-supply of housing in England*[1], some 217,000 new homes were built in 2016/17. This was 15 per cent more than in previous years, but still short of the target. In February 2018, the government published its white paper *Fixing our broken housing market*[2]. While short on detail, this paper showed an intent to increase the pace of house building.

The 2018 Budget announced various measures to support development, including extending Help to Buy to March 2023 and adding £500million to the Housing Infrastructure Fund.

More locally the Oxford – Milton Keynes – Cambridge Growth Corridor is a particular focus for development. £140million has been allocated to the National Productivity Investment Fund for the Growth Corridor. East West Rail and the Oxford to Cambridge Expressway are significant infrastructure projects which provide the backbone to the corridor. With them we expect to see a significant expansion in knowledge lead industry and home building; the National Infrastructure Commission estimates 1million new homes will be required.

For farmers and rural landowners looking to diversify their income stream post-Brexit, this development may represent a new source of funds, which can be invested into the existing business. These funds can also help with succession planning. In particular, the additional capital receipt made from selling non-core assets can provide an opportunity to be fair to other non-farming members of the family upon death.

This document sets out what farmers and other rural landowners need to know when the developer calls, in order to capitalise on these opportunities.

What you need to understand

Land ownership

If there is a development opportunity for your land, the first thing you need to understand is who owns the land itself.

Establish exactly who owns land – in particular, whether or not it is a partnership asset. Pinpointing ownership is critical to any tax planning. If the title is not yet registered at HM Land Registry get it registered. It will provide more certainty as to ownership and boundaries. Also any developer will want to see the title registered.

[1] https://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-7671
[2] https://www.gov.uk/government/publications/fixing-our-broken-housing-market

Timescale

Promoting strategic sites for development can take time and money. You need to identify where in the development timeline you are. Typically, the timeline is:

1. The land is identified as a possible development site, but it remains allocated outside development areas
2. It is proposed for allocation in the Local Plan
3. It is allocated
4. The owner obtains planning permission

The earlier in this process you are, the lower the land value. Therefore, the best time to do any restructuring may be early on. Restructuring may involve passing land ownership down a generation, moving it into a trust, or putting in place other structures. This has to be balanced against the tax risks and the risk that the land does not come forward for development.

Scale of development

Next, you must understand the likely scale of the development. This will allow you to consider:

1. **The amount that you will receive**
   This will affect what you can do with the money, as well as the tax liability, which may, in turn, help determine how much you wish to spend on professional advice.

2. **How the land will be sold**
   If the development may be sold in one go to a single buyer, you have a single sale (or tax point) to plan for, simplifying matters. If, on the other hand, there may be multiple sales, you may have multiple disposals (and so tax points) to consider.

Taxing Single Sales

Is the land used in a trade?

When looking at the tax treatment of development land, the first thing to consider is whether the land is currently used as part of a trading business. This is because the tax codes tend to be more generous when dealing with business assets.

Therefore is the land used within the farming business? Land that is not likely to qualify as a business asset includes redundant land, let land and land on which trading activities are not adequately robust.

If your land will not qualify, you may wish to consider how to bring it into trade. For example ending the tenancy of the business currently occupying the land, in order to start your own trade there, or joining the tenant's business.

If you are concerned that the trading activities are weak, work through HMRC's 'Badges of Trade BIM20205' guidance, which can be found here: https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim20205. If you cannot demonstrate strong badges of trade, the land may not qualify as a business asset.

Grazing agreements

The attraction with grazing agreements is that, potentially, a trade can be set up on a relatively small area of land, turning that land into a business asset. However the risk is the level of business activity may not be sufficient to amount to a trade.

HMRC will review the agreement very carefully. It will examine the nature of the agreement and the parties' actions. To satisfy HMRC, you need to show that the grass is being grown as a crop. For this, you should ideally be able to demonstrate that you, as landowner, are buying and applying input like fertiliser, as well as maintaining boundaries, etc.

Contract farming

If you do not have the farming equipment to farm the land yourself, one possibility is to enter into a contract farming arrangement. You will need a suitable agreement in place and this must involve you sharing the risk of trade, controlling the farming and attending regular meetings with the contractor. You will need to fund the farming activity paying for inputs. Your accounts must show how your profit share is calculated after expenses have been deducted. The relevant HMRC guidance is BIM55070-55090.

You may also wish to consider using the land yourself for a trade other than farming.

Trading in Land

Whilst the land should be used in a trade you do not want to be seen to be trading in land; this risks a charge to Income Tax which can be as high as 45 per cent, as opposed to Capital Gains Tax which can be as low as 10 per cent.

The Transactions in Land rules – introduced by the Finance Act 2016 – apply where land is acquired or developed with a main purpose of realising a profit from disposing of it. Any profits from the disposal will be subject to Income Tax. The rules are designed to counter contrived avoidance schemes, not the genuine investor, but they are very widely worded.

HMRC has confirmed that the provisions do not override the general distinction between trading and investment in straightforward transactions, so you must also consider the general income tax principles. The relevant HMRC guidance is covered from BIM60515 onward.

The critical issue is whether the land has been appropriated to trading stock. If it has, any profits will be subject to Income Tax, under the general principles. In your accounts and all supporting documentation, you will need to show the land as a capital asset.

HMRC will also examine how the land was acquired, your intention on acquisition and the amount of work carried out on the land. If HMRC sees a clear change of intention in relation to the land, then it may argue that the land has been appropriated to trading stock. Simply obtaining planning permission is generally not enough to convert an investment into a trade.

If carrying out infrastructure works on the land, you must be careful. This could show a change of intention to convert the land to trading stock if you fail to stick within HMRC guidelines. Generally, road and sewerage works are safe, but anything more extensive, such as buildings or football pitches, might be considered trading. If there is a commercial need to carry out these types of works, you might consider setting up a special purpose vehicle through which to engage the contractors.

You must also be careful with any arrangement that gives you an extra payment based on the development's success. If not caught under general principles, such arrangements are likely to be caught under the Trading in Land rules.

Capital Gains Tax

Assuming the proceeds are subject to CGT, tax on the gain may be at 20%. Historically this is a low rate. However there are reliefs that may be available, including Business Asset Rollover Relief and Entrepreneurs' Relief to reduce or defer the liability.

Rollover relief is available on the sale of business assets, including land used in a trade. The relief is a deferral relief meaning that tax is not paid on the sale of the land, if the proceeds are used to buy new business assets within the relevant time. This relief will reduce the base cost of the newly-acquired asset, meaning that when you sell the new asset you may end up paying tax on the increase in value of the development land and the new asset. If you keep the asset until death you may benefit from an uplift of the base cost and the rolled over gain is washed away. However, Inheritance Tax may be payable. You may want to invest the proceeds into farmland to reduce the impact of Inheritance Tax, but in areas of high development you may find many people are looking to rollover the proceeds into new farms, driving up values.

It may be preferable to pay the tax now while the rates are low, rather than risk paying higher rates later. If you can claim Entrepreneurs' Relief, the rate is as low as 10% on gains up to £10million (the lifetime allowance). Entrepreneurs' Relief is available to a sole trader if:-

- they are selling the whole or part of a business, rather than just land; or
- if the land is used in their trading business and it is sold within 3 years of the business ceasing to carry on.

You must have owned the business for at least 1 year. This qualifying period is increasing to 2 years from April 2019.

If you are looking to claim Entrepreneurs' Relief, you need to plan carefully to ensure the business has been set up correctly, has run for the requisite period of time, that there is a proper cessation or disposal of a qualifying interest before you contract to sell the land and that all the conditions are met.

Partners and shareholders may also qualify for the relief if they meet the conditions relevant to them.

Inheritance Tax

The value of land can increase significantly if it can be used for development. With Inheritance Tax at 40% preserving Inheritance Tax reliefs a key consideration.

Agricultural Property Relief can be available if the land is used for agriculture but is limited to the agricultural value. It does not cover hope or development value, whilst Business Property Relief can. Therefore qualifying for Business Property Relief can be critical. However remember both reliefs are lost when there is a binding contract for sale. Also Business Property Relief will be lost if the business is wholly or mainly an investment business, again illustrating the importance of the asset being part of a trade. Once the property is sold the reliefs are lost as they do not apply to cash.

Gifts to the next generation or into trust are frequently used to try and mitigate inheritance tax. However there are various factors to consider such as

- CGT on the gift (although holdover relief may be available)
- there will be no CGT uplift to the base cost on death
- do you need the income from the land because if you give the land away, but keep income arising from it, you risk the gift not being effective for Inheritance Tax planning
- will you have sufficient left to justify keeping APR on the farmhouse
- does the donee of the gift risk being seen as acquiring the land with the intention of selling it for development? If so is there a risk that the Transaction in Land rules could be engaged

Good Housekeeping

As well as considering tax make sure your general affairs are in order. Is your Will up-to-date to ensure the development land, or proceeds, are passed the correct people? Also do you have a Lasting Power of Attorney so matters continue even if you are unable to sign the relevant paperwork?

Multiple sales

You may have multiple sales if:

1. **The planned development is a large residential site**
   A single house builder can only build and sell so many houses at once. Therefore, if it bought an entire large site in one go, it could take years to build and sell all the houses. The delay in the return on the investment (Return on Capital Employed (ROCE)) is important to many house builders and means they will want a discount. You may achieve a higher price by selling the land in smaller tranches to different house builders, as each will see a quicker ROCE.

2. **You are selling storage and distribution units**
   The developer will want to find a fund or owner/occupier to take the land before it is bought from the owner. This means that the developer may want to take the units one at a time.

Equalisation

If the development is to be a larger scheme with multiple sales, you may also have multiple landowners. In these cases, you will also need to deal with equalisation.

Equalisation can mean various things to different people. Broadly, it means trying to equalise receipts on sale between landowners (see 'Equalisation example' box).

Equalisation example

Consider a site with three landowners –Bill, Hartley and Lawes. As a whole, the site has planning permission for 1,000 houses, a school and a large roundabout. The site also has usual open space and Sustainable Drainage Systems (SuDS) requirements.

Bill's land is to be used for 500 houses. Hartley's will have 250 houses and the school. Lawes' will have 250 houses and the roundabout. Each person owns precisely one third of the gross area.

On one analysis, Bill's land is the most valuable, as it will contain the most houses and there is no school or roundabout to build (the school and roundabout sites will not be sold to make money; they are the cost of development).

However, Hartley and Lawes argue that without the school and roundabout, Bill's houses cannot be built, because there will be no access and the school is a required planning condition. Therefore, Hartley and Lawes say, the proceeds of the entire site should be split by area – one third each. That is, the values should be 'equalised' across the entire site.

Landowners may try to equalise by simply ensuring that each time a tranche of land is sold they each sell part of the tranche. Then the price of each tranche is agreed so that by the time all of the site is sold each of landowner has received a third of the total receipts. This only works if you can guarantee all of the land will be sold, the market is relatively stable throughout the sale period and each landowner has land within each tranche. Frequently maters are not that simple. If one landowner has all of the land in the first tranche and agrees to pass 1/3 of the receipt to the other two landowners, the landowner selling will be taxed on 100% of the receipt and the other two will be taxed on the money they receive, the double taxation trap.

Avoiding double taxation

There are various ways to try and avoid double taxation when equalising.

Pool trusts can be used. These are bare trusts where the pooling landowners transfer the development site into joint ownership so the land is held as beneficial tenants in common. Each landowner will therefore go from having 100% of his part of the site to having a smaller percentage interest in the whole of the site. HMRC currently accept that so long as the value of the landowners land before pooling equates to the value of the percentage interest in the pooled land there is no CGT or stamp duty land tax on pooling. HMRC have accepted this with some reluctance so this must be kept under review.

Considerations if Pooling

If pooling the valuations are critical to avoid CGT and SDLT on creating the pool trust. So careful consideration needs to be given as to how to approach the valuation.

Once pooled a single landowner will go from owning a 100% interest in land that he occupies and uses in his trade to having a smaller percentage share in a wider area of land, much of which he will not occupy or use in his trade. This may make it more difficult to obtain BPR, rollover relief and Entrepreneurs' Relief as all these reliefs are aimed at relieving tax on business assets. The landowners could try to overcome this by one or more of them farming the development site. If one landowner farmed the entire site it may enable him to protect most of the reliefs, but farming a site where parts are being sold for development could be difficult.

If more than one landowner wants to farm the site they may need to consider entering into partnership to farm the site together. If they do this they may wish to avoid making the land itself a partnership asset as that could result in an SDLT charge and increase the risk of there being a Transaction in Land. However if the land is held outside the partnership BPR will be limited to 50% of the value of the land.

Cross Options

As an alternative to pooling landowners could grant each other cross options. Here each landowner keeps his land but grants the other landowners an option to acquire an interest in his land. The interests that can be acquired under the option equates to the percentages they each have under the equalisation agreement. So if three landowners agree to equalise by splitting the proceeds 1/3 each they will each grant the other landowners as option to acquire a 1/3 interest in their land. Then each landowner has his land subject to options allowing others to acquire a total 2/3 interest in his land, and he has an option to acquire a 1/3 interest in the other's land. When a tranche is sold each landowner will sell either the land or his option over the land.

Cross options need to be created at early stage because the grant of the option can trigger a CGT charge. As this will be before any land is sold, a dry CGT charge, you want to ensure the value of the option is kept low. Also the option is not a trading asset and so BPR, rollover relief and Entrepreneurs' Relief are unlikely to be available on the value of the options.

Other Structures

There is no one perfect equalisation structure. We have set out two commonly used structures but landowners can also consider:

- Selling via a joint Special Purpose Vehicle
- Granting cross restrictive covenants
- Cross Conditional Sale contracts

Land value capture

"Developer" Contributions

When development is permitted the developer is often asked to make financial contributions or carry out physical works to ensure that the necessary infrastructure is provided to support the development. These are made under section 106 of the Town & Country Planning Act or through the Community Infrastructure Levy (CIL). These are frequently referred to as developer contributions, but the cost is, in reality, borne by the landowner. This is because the landowner receives the residual value after development costs (which include items such as the cost of building the houses, putting in roads and other services, the developer's profit and the amounts that must be paid under Section 106 Agreements and CIL). Typically the landowner will receive between 50% and 75% of the uplift in value of the land.

Section 106 Agreements

Section 106 Agreements are agreements entered into between the landowners, the local authorities and the developers, and are designed to make an otherwise unacceptable development acceptable by ensuring that there are adequate facilities such as schools, doctors' surgeries and/or roads to accommodate the increased population without the local or central government having to bear all the cost.

Community Infrastructure Levy (CIL)

CIL is a flat rate charge made by the local authority on development where the local authority has adopted a CIL charging schedule. Rates vary depending on the type of development and the area where development takes place.

CIL is designed to collect funding for infrastructure that can be used by the local authority, not just in connection with the development in question, but elsewhere within its area.

The various processes by which local and central government take a share of the uplift in the value of land following the grant of a planning permission is called "land value capture". S106 and CIL are the two mechanisms by which most value is captured, though that is not their primary aim.

Increasing land value capture

Because of increasing demand for infrastructure and increasing house prices and land values, especially in areas of high growth, the government is reviewing current methods of land value capture in the hope that local and central government will benefit more from public decisions such as planning permissions and infrastructure schemes. It is worth keeping an eye on developments in this area because a substantial change could make a significant difference to the amount of profit to be made from development land.

The government is considering making changes to the compulsory purchase rules so as to make it more feasible for local authorities to use compulsory powers to acquire land to promote development, but in the recent budget no major new change was announced. Instead, changes have been made in planning policy guidance to the way in which local authorities are to deal with the question of the viability of developments (which is to be assessed very early in the process) and with setting out in the local plan what contributions will be required. This is intended to ensure that the necessary facilities are provided and also to ensure that developers do not pay excessive amounts for land and then say that they cannot afford, as a result, to pay for the facilities. A "Strategic Infrastructure Levy" has also been proposed, which, if it comes into effect, will be a universal levy (in affected areas) on all development to cover the cost of infrastructure which benefits a wide area.

Anyone putting forward land for development needs to be realistic about the need to finance and provide facilities. This will ease the passage of the application and avoid unwelcome interference through the use of compulsory purchase, where the development is strategic in type or scale. Well provided developments are also more valuable and saleable than those with poor facilities, so it is not worth skimping. Having said that, it is also of key importance to ensure that the requirements being imposed are reasonable and proportionate. The time at which payments have to be made is also key to cash flow and the ability to satisfactorily divide sites up and sell them in phases.

Some landowners, where a developer is involved, take the view that the section 106 agreement is not their concern as they will be selling the land. For the reasons that we have given above and for other reasons which may be particular to the transaction, we advise that landowners pay close attention to the section 106 obligations being proposed in relation to their land.

Conclusion

As you can see from this document, there are many important areas for farmers and other landowners to understand if they are to effectively capitalise on development opportunities. It is important that you familiarise yourself with these matters before the developer calls, so begin planning now. For extra peace of mind, consider enlisting the services of a law firm with dedicated teams specialising in not only development work but also in agricultural law, private wealth and succession planning. These are complex, intricate areas of law in which not every firm can deliver.

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